



ANNUAL 2005 REPORT

U.S. Department of Education
Federal Student Aid



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FEDERAL STUDENT AID

Annual Report FY 2005

Federal Student Aid, an office of the U.S. Department of Education, ensures that all eligible individuals can benefit from federally funded or federally guaranteed financial assistance for education beyond high school. We consistently champion the promise of postsecondary education to all Americans—and its value to our society.



Dear Federal Student Aid Colleagues, Partners and Customers,

I am pleased to present Federal Student Aid's Annual Report for FY 2005. This publication documents the progress we have made in increasing program integrity, improving customer service and achieving measurable advances in the management of the Title IV student financial assistance programs.

In FY 2005, Federal Student Aid disbursed \$73 billion in aid to more than ten million students attending more than 6,100 schools. We also managed an outstanding loan portfolio of \$391 billion. These levels of performance represent new standards for our team and have been achieved as we have continued to reduce our direct unit costs of operation and substantially increase our productivity. We are working enthusiastically to sustain this track record of continual progress, which has distinguished the operations of Federal Student Aid since 1998 when Congress named us the government's first Performance-Based Organization.

In January 2005, the Government Accountability Office removed our programs from its High-Risk List. For our team, this action both validated and rewarded our ongoing commitment to strengthen the integrity of the Title IV student financial assistance programs and minimize their exposure to potential fraud, waste, abuse and mismanagement. This year, we also established a risk management group to enhance our ability to identify, assess and manage potential future risks across the enterprise.

I am also pleased to point out that our major system integration efforts—notably Common Services for Borrowers and ADvance—are progressing under focused project and contract management oversight to ensure successful delivery. These initiatives will vastly improve services to our many stakeholders and save taxpayers millions of dollars in operating costs. FAFSA on the Web also continues to exceed expectations, again achieving world-class customer satisfaction scores in FY 2005. Ninety percent of the 14 million applications submitted annually are now completed electronically, a visible testimony by our customers that our efforts to streamline and improve the federal student aid application process are hitting the mark. Additionally, this extremely high adoption rate of our electronic application services results in improved efficiency, higher productivity and greater return on our investment.

The year also presented some unanticipated challenges. In August and September, hurricanes devastated the Gulf Coast region, jeopardizing the continued studies of nearly 100,000 postsecondary students. Our team responded quickly, reallocating key resources to ensure effective delivery of our services to these displaced students and to the host institutions receiving them as well as to those institutions impacted by the storms.

The continued progress of Federal Student Aid is driven by our more than 1,000 talented and dedicated employees with whom I am privileged to work. This report is presented on their behalf and is a reflection of their many accomplishments as well as their passion and commitment to our mission.

Sincerely,

Theresa S. Shaw
Chief Operating Officer



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Federal Student Aid, a principal office of the U.S. Department of Education (the Department), ensures that all eligible individuals can benefit from federally funded or federally guaranteed financial assistance for education beyond high school. We consistently champion the promise of postsecondary education to all Americans—and its value to our society.

Federal Student Aid plays a central and essential role in supporting postsecondary education. We partner with postsecondary schools, financial institutions and other participants in the Title IV student financial assistance programs (Title IV programs) to deliver programs and services that help students finance their education beyond high school. Today, Federal Student Aid is responsible for a range of critical functions that include, among others:

- Processing millions of student financial aid applications;
- Disbursing billions of dollars in aid funds to students through schools;
- Enforcing financial aid rules and regulations;
- Partnering with schools, financial institutions and guaranty agencies to prevent fraud, waste and abuse;
- Educating students and families about the process of obtaining aid;
- Servicing millions of student loan accounts;

- Securing repayment from borrowers who have defaulted on their loans; and
- Operating information technology systems and tools that manage billions in student aid dollars.

This is a complex, multifaceted mission that calls on a range of staff skills, and demands coordination by all levels of management. Designated a Performance-Based Organization (PBO) by Congress in 1998, Federal Student Aid emphasizes tangible results and efficient performance, as well as the continuous improvement of the processes and systems that support our mission.

This annual report summarizes Federal Student Aid's FY 2005 performance activities. Federal Student Aid's annual performance initiatives are based on two strategic planning documents, the *Five-Year Plan* and the *Annual Performance Plan*. Federal Student Aid's *Five-Year Plan*, issued in annual editions, is a cumulative statement of strategic direction articulating our long-term objectives. Based on the *Five-Year Plan*, Federal Student Aid's *Annual Performance Plan* establishes specific tactical initiatives to achieve each of our core strategic objectives.

In addition to summarizing Federal Student Aid's FY 2005 achievements, the annual report includes the following:

FY 2005 Tactical Accomplishments (Appendix A)
FY 2005 *Annual Financial Report* (Appendix B)

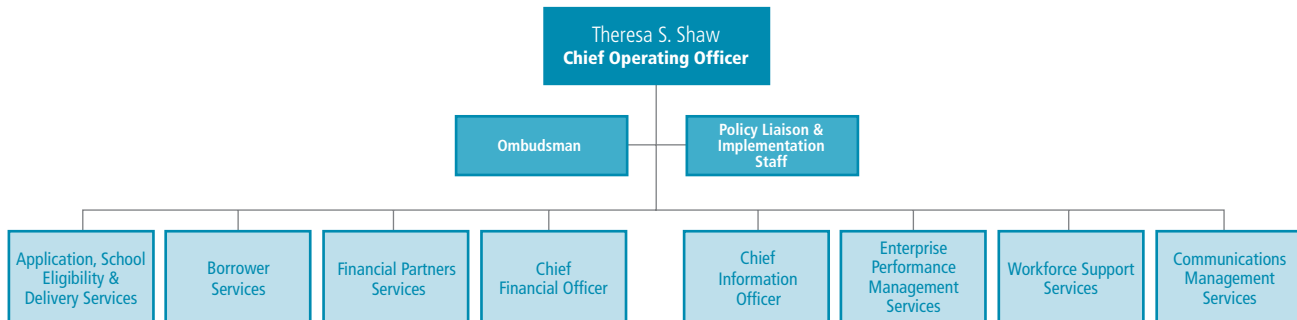


ABOUT OUR ORGANIZATION

Federal Student Aid currently operates under a functional structure that aligns our organization closely with our strategic drivers, business objectives and mission goals. This structure reinforces a key business goal: efficient and productive interaction with our many stakeholders.

This community of stakeholders includes students and parents, schools, lenders and guaranty agencies as well as other federal entities and the Department of Education itself. The graphic below illustrates the current functional structure of Federal Student Aid.

Federal Student Aid Organizational Structure

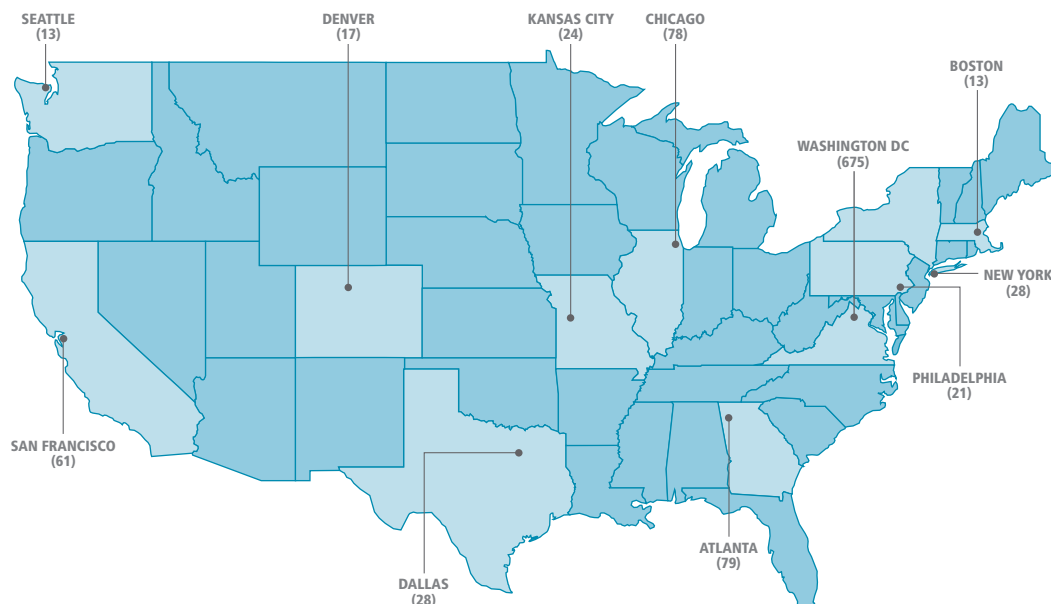


Chief Operating Officer (COO) Theresa S. Shaw, who was appointed to a five-year term by the Secretary of Education in 2002, leads Federal Student Aid. In fiscal year 2005, the organization operated on an annual administrative budget of \$631 million. Our staff of nearly 1,050 is augmented by

contractors who provide outsourced business operations. This workforce is based at locations throughout the country, including ten regional offices in addition to the Washington, D.C. headquarters.

The map below highlights the locations of Federal Student Aid regional offices by city and state, with the number of Federal Student Aid employees based at each location indicated in parentheses.

Federal Student Aid Regional Map



As a federal-designated PBO, Federal Student Aid operates under a congressional mandate to achieve concrete mission results as we improve efficiency in performance. Federal Student Aid has focused on innovations for upgrading student aid delivery and servicing operations, vendor

and contract management, budgeting and cost control and financial and operational management. Much of the resulting performance improvement will stem from business process reengineering and large-scale technology integration.



Federal Student Aid is responsible for helping students manage the costs of education beyond high school. This duty includes administering the federal student financial assistance programs authorized under Title IV of the Higher Education Act (HEA) of 1965, as amended. The Title IV student financial assistance programs collectively represent the nation's largest source of financial aid for postsecondary students. In the paragraphs that follow, we briefly describe each of the major Title IV programs that deliver federal student aid to students and their families.

The **Federal Pell Grant (Pell Grant) Program** helps ensure financial access to postsecondary education by providing grant aid to low- and middle-income undergraduate students. The most need-focused of the Department's student aid programs, Pell Grant awards vary according to the financial circumstances of students and their families. For the 2004-2005 award year, the Department disbursed \$13.1 billion in Pell Grants averaging \$2,469 to 5.3 million students. The maximum Pell Grant award remained at \$4,050 for the 2004-2005 award year.

The **Federal Supplemental Educational Opportunity Grant (FSEOG)**, the **Federal Work-Study (FWS)** and the **Federal Perkins Loan (Perkins) Programs** are three campus-based programs through which the Department provides funds directly to eligible institutions, enabling

them to offer grants, employment and low-interest loans based on student need. For the 2004-2005 award year, the Department disbursed approximately \$3.3 billion in campus-based awards to approximately three million recipients.

There are two **state grant** programs. The **Leveraging Educational Assistance Partnership (LEAP) Program**, authorized by Section 415A of the HEA of 1965 (as amended) makes federal funds available to assist states in providing student financial assistance programs for individuals with substantial financial need. The **Special Leveraging Educational Assistance Partnership (SLEAP) Program** was added to the LEAP Program in the 1998 Amendments to the HEA (Section 415E). SLEAP makes federal funds available to states to cover a third of the cost of supplementing their respective LEAP programs, supplementing their LEAP Community Service Work-Study programs, and/or providing Merit and Academic Achievement, or Critical Careers Scholarships, to students with substantial financial need.

Two major student loan programs account for nearly all of the remainder of the Department's financial assistance for postsecondary education. Loans can either be subsidized or unsubsidized. With subsidized loans, the government pays the interest while the student is in school and during qualified periods of grace and deferment. This is not the case with unsubsidized loans.



FEDERAL STUDENT AID'S PROGRAMS *continued*

The **Direct Loan Program** lends funds directly to students through participating schools. The Department borrows these funds from the U.S. Treasury. In FY 2005, the Department made \$12.8 billion¹ in net loans to 1.9 million Direct Loan Program recipients.

Funds for the **Federal Family Education Loan (FFEL) Program** are provided by private lenders. Loan guaranty agencies insure these funds, and they are reinsured in turn by the federal government. During FY 2005, Federal Student Aid supported the delivery of \$43 billion² in net loans to 5.8 million FFEL recipients. In the same fiscal year, Federal Student Aid paid an estimated \$5.1 billion to lenders for interest and special allowance subsidies, and an estimated \$4 billion to guaranty agencies. This latter amount comprises fees paid to guaranty agencies for loan processing, issuance and account maintenance (as required by the HEA) and reimbursements for defaulted FFEL loans.

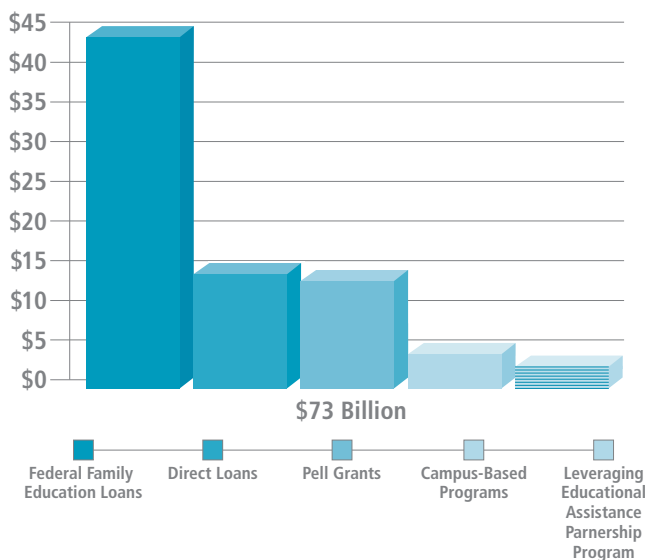
In FY 2005, Federal Student Aid delivered or supported the delivery of approximately \$73 billion³ in federal aid to approximately 10 million postsecondary students and their families. The students that Federal Student Aid helps attend more than 6,100 institutions of postsecondary education accredited by dozens of agencies. Many of these students receive loans from approximately 3,200 lenders with 35 agencies guaranteeing those loans.

In fulfilling our program responsibilities, Federal Student Aid directly manages or oversees more than \$391 billion in outstanding loans—representing almost 80 million student loans to over 26 million borrowers.

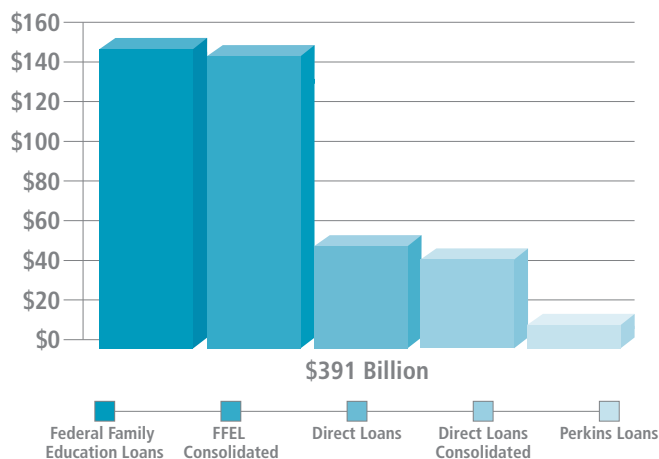


The graphic below illustrates the fiscal scope of Federal Student Aid's operations in FY 2005.

Total New Federal Aid



Total Federal Student Aid Loan Portfolio



¹ Excludes consolidation loans of \$17.7 billion.

² Excludes consolidation loans of \$50.8 billion.

³ Federal Student Aid's FY 2005 Management Discussion and Analysis (MD&A) reported projected total aid of \$74 billion. The figure reported in this document reflects actual total aid delivered for FY 2005.



Since Federal Student Aid was named the federal government's first PBO in 1998, we have introduced many concrete and measurable improvements in how we plan and report our performance in administering the federal student financial assistance programs.

Strategic Planning and Reporting

Several key strategic drivers inform the scope and content of Federal Student Aid's long-term goals and objectives:

- The President's Management Agenda (PMA)
- The Government Accountability Office (GAO) High-Risk List
- PBO legislation
- The Department's Strategic Plan
- Customer needs

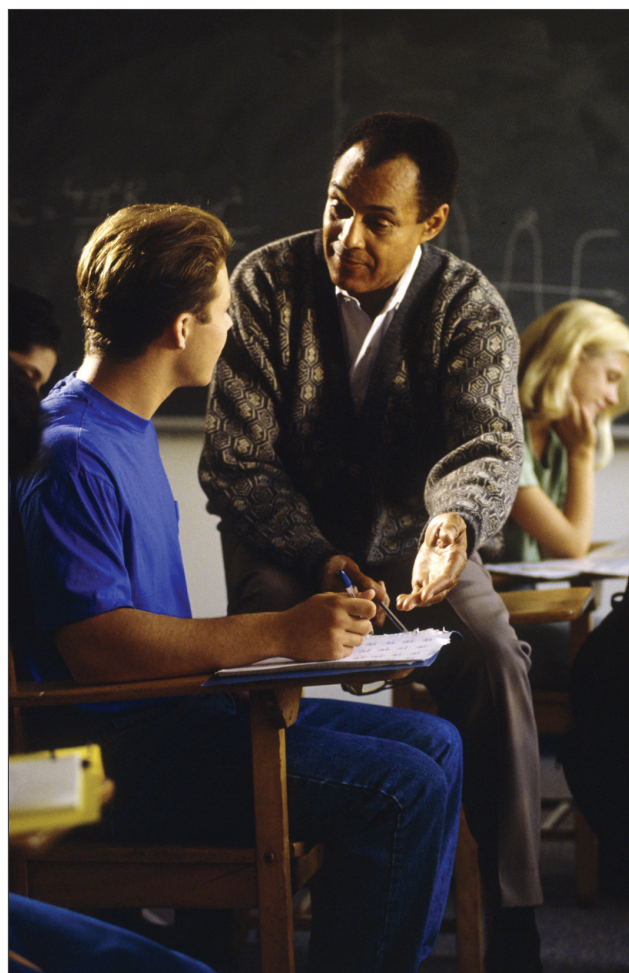
The foundation of our long-term strategic planning is Federal Student Aid's five core strategic objectives. Taken collectively, these objectives provide the framework for continuous improvement at Federal Student Aid, guiding us in managing our programs more effectively and providing clear strategic direction to all of Federal Student Aid's internal and external constituencies.

Our core strategic objectives are:

1. To integrate Federal Student Aid systems and provide new technology solutions to deliver federal student aid in an efficient and cost-effective manner;
2. To improve program integrity to ensure access to postsecondary education while reducing vulnerability to fraud, waste and abuse;
3. To reduce program administration costs to improve control over resources and maintain accountability for results;
4. To improve human capital management; and
5. To improve products and services to provide better customer service.⁴

⁴ A sixth objective, *Deliver Student Aid Effectively and Accurately*, was added to Federal Student Aid's Annual Performance Plan to facilitate reporting on the performance of day-to-day operational activities. Although the sixth objective was reported in the 2004 Annual Report and MD&A, it is an operational performance goal. Accordingly, it will continue to be part of Federal Student Aid's Annual Performance Plan but it will not be separately addressed as a strategic objective in future reports.

Federal Student Aid's long-term planning is outlined in its **Five-Year Plan**, a statement of strategic direction providing long-term guidance. Beginning with the FY 2006 – FY 2010 **Five-Year Plan**, Federal Student Aid will establish and document strategic performance standards to measure the organization's success in meeting the stated long-term objectives. Federal Student Aid will begin reporting our performance as measured by these established standards in the FY 2006 **Annual Report**.



Tactical Planning and Reporting

Federal Student Aid's ***Annual Performance Plan*** establishes specific tactical initiatives to achieve each of the organization's strategic objectives outlined in the ***Five-Year Plan***. Timelines, milestones and status are tracked in the ***Annual Performance Plan*** and evaluated on a monthly basis to ensure their alignment with current business needs, the allocation of resources, the availability and allocation of capital and operating funds, policy considerations, and statutory and regulatory requirements. See Appendix A for a summary of Federal Student Aid's FY 2005 tactical accomplishments against this plan.

This document, the ***Annual Report***, provides the mechanism for reporting the organization's annual tactical performance results including the organization's audited financial statements and the organization's progress in meeting tactical goals established in the ***Annual Performance Plan*** (See Appendix A). These three documents —the ***Five-Year Plan***, the ***Annual Performance Plan*** and the ***Annual Report***— form the foundation of Federal Student Aid's strategic planning, tactical implementation and reporting processes.

Additionally, Federal Student Aid continues to improve the systems and procedures used to identify, budget, select, monitor and improve operations. Performance monitoring includes weekly project planning and reporting activities detailing the scope, schedule, cost, quality and overall status of key initiatives. Federal Student Aid's budget management processes and our unit-cost model provide cost identification, control and management. Federal Student Aid also continually tracks and reports enterprise-wide operational, human capital and performance metrics through a series of dashboard reports.



The following paragraphs provide highlights of Federal Student Aid's FY 2005 significant accomplishments. See Appendix A for a detailed list of FY 2005 accomplishments.

STRATEGIC OBJECTIVE ONE

Integrate Systems and Provide New Technology Solutions

—Completed several system and business process integration initiatives as part of a multiyear, integration-sequencing plan:

- Awarded the ADvance contract, an initiative to modernize and integrate the organization's core front-office business functions through the reengineering, retirement and replacement of existing aid delivery systems. Formerly called the Front-End Business Integration initiative, the ADvance solution fully integrates the Pell Grant award and Direct Loan origination and disbursement processes. The ADvance solution consolidates and streamlines common functions, providing an end-to-end, online view of financial aid information for customer service representatives, schools and students.
- Continued implementation of the Common Services for Borrowers initiative, a solution that consolidated Federal Student Aid's back-office systems for Direct Loan Servicing, Consolidation and Collections into a single integrated solution projected to save \$1 billion over the life of the contract.
- Led and/or participated in many of the 24 President's Management Agenda (PMA) E-Gov initiatives. Our current Office of Management and Budget (OMB) E-Gov scorecard reflects progress as "green" for the Department of Education on these initiatives. For example, we were the managing partner for eLoans and successfully graduated the initiative into a Federal Credit Council and built and deployed GovLoans.gov as part of GovBenefits.gov (another PMA initiative). Federal Student Aid also led the Department's efforts for E-Authentication, GovBenefits, Business Gateway and USA Services.

STRATEGIC OBJECTIVE TWO

Improve Program Integrity

—Federal Student Aid has institutionalized sound financial management and internal controls at every level of the organization:

- Accomplished our top program integrity priority with removal of Federal Student Aid programs from the GAO High-Risk List after remaining on that list for 14 years.
- Contributed to the Department of Education's achievement of a "green" designation for the status rating on the PMA initiative *Improving Financial Performance* and enabled Federal Student Aid to move to a "green" designation for the progress rating on the PMA initiative *Eliminating Improper Payments*.
- Attainment of a "green" designation for both status and progress ratings on the PMA initiative *Elimination of Fraud and Error in the Student Aid Programs and Deficiencies in Financial Management*.
- Achieved a historic low rate of 4.5 percent for the National Cohort Default Rate for FY 2003, a reduction of 13.5 percent from the FY 2002 rate of 5.2 percent.
- Achieved our fourth consecutive unqualified audit opinion in FY 2005, citing no material weaknesses in internal controls. This sustained achievement was critical to Federal Student Aid's removal from the GAO High-Risk List and is the result of substantial improvements to internal controls, continued improvement in our accounting and financial processes and Federal Student Aid's strategic planning and financial reporting.

STRATEGIC OBJECTIVE THREE

Reduce Program Costs

—Decreased the unit administrative cost of delivering student aid programs through efficiency and productivity gains in our business processes. These gains allow Federal Student Aid to successfully manage dramatically increasing workloads:

- Improved management and control of operating expenses through efficiencies, productivity gains and capital savings. Our FY 2006 operating expense budget has been reduced to 45 percent of the total budget versus 54 percent of the total budget in FY 2000. Over the same period, FAFSA applications have increased by almost 35 percent, the dollar volume of loans has grown by 85 percent, unduplicated borrowers have increased 55 percent and the number of loans has increased by 63 percent.
- Established FY 2003 and FY 2004 unit-cost measures based on actual expenditures and performance measurement data. Using these measures we were able to project unit costs for FY 2005 – FY 2009 and support our funding needs in our FY 2007 budget submission.
- Reduced collection costs by 30 percent since FY 1997 while increasing default collections by over 240 percent. In FY 2005, Federal Student Aid renegotiated our private collection agency contracts, further reducing the cost to collect by 13 percent over the next three years and projecting an additional 25 percent increase in default collections over the same period.

STRATEGIC OBJECTIVE FOUR

Improve Human Capital Management

—Continued to develop a work environment that encourages high performance and promotes professional growth to ensure Federal Student Aid attracts and retains a skilled, knowledgeable and motivated workforce:

- Improved succession-planning capabilities by identifying areas within the organization where subject matter expertise needs strengthening due to the pending retirement of senior employees.
- Achieved significant progress in performance management by clearly differentiating among performance levels and the delivery of real results.

STRATEGIC OBJECTIVE FIVE

Improve Customer Service

- Improved service to customers through process reengineering, innovation and improvement and by increasing customer awareness, access and self-service.
- Scored in the “Excellent” and “Good” range of the FY 2005 American Customer Satisfaction Index (ACSI) ratings for Federal Student Aid’s highest volume products and services – including Direct Loan Servicing, FAFSA on the Web, the Common Origination and Disbursement System and the Lender Reporting System. Federal Student Aid products score higher than federal government averages and on par with private sector organizations such as UPS, Amazon.com and financial services companies such as JP Morgan Chase, Bank of America and Wells Fargo.
- Launched a multiyear enterprise communications strategy in FY 2005 to better articulate the benefits of postsecondary education, raise awareness of Federal Student Aid’s programs and improve consistency across all communications to our many stakeholders, including currently underserved communities. In addition, this strategy establishes partnerships with organizations at national, regional and local levels that have the common goal of promoting awareness of and access to aid for postsecondary education.

Annual Bonus Awards

As a result of these accomplishments, eleven performance bonuses were awarded to the executive managers of Federal Student Aid. A performance bonus of \$65,000 was awarded to the COO. Ten performance bonuses were awarded to other executive managers. These awards ranged from \$10,000 (7.4 percent of annual salary) to \$28,900 (19.85 percent of annual salary) with a median award of \$15,300 (10.51 percent of annual salary).



Established by the 1998 Amendments to the HEA, Federal Student Aid's Ombudsman Office uses an informal dispute resolution process to address complaints from financial aid recipients. Working with students, borrowers, lenders, loan guaranty agencies and schools, the Ombudsman Office analyzes complaint data to identify broader systemic issues impacting the Title IV financial assistance programs.

Information about the Federal Student Aid Ombudsman Office is disseminated throughout the student loan application and repayment process. The Ombudsman also maintains a Web site (www.ombudsman.ed.gov), produces collateral material to provide the higher education community with additional information on its services and meets with other agencies to address issues common to the industry.

Since its inception, the Federal Student Aid Ombudsman Office has handled more than 85,000 complaints, including 14,775 cases in FY 2005. The Ombudsman Office resolved over 71 percent of FY 2005 cases within one to three days of the initial complaint and took an average of 117 days

to resolve approximately 4,265 cases requiring additional research and due diligence. Of those 4,265 cases requiring additional effort, the average borrower had 8.3 loans, an increase from the average of 6.5 loans in FY 2004. Only 22.12 percent of those borrowers' loans are in default; another 4.46 percent were in default at some point before the Ombudsman Office received the case. Almost one-third, or 32.76 percent, of the loans have been in repayment for less than five years.

The effectiveness of the Ombudsman Office is measured through customer feedback facilitated by weekly surveys. Cases are chosen at random, and borrowers are asked to rate service accessibility, representatives' knowledge, timeliness of resolution, level of satisfaction with their resolution and overall service. Each item is measured on its own scale and is part of a weighted average for overall satisfaction. On a scale of 1 - 5, where 5 is the highest rating, results are calculated weekly and cumulatively. The Ombudsman considers only ratings of 3.75 and above as meeting its performance goals. The final overall satisfaction rating for the FY 2005 research cases was 4.39.



LEGISLATIVE AND REGULATORY RECOMMENDATIONS

Key among Federal Student Aid's mission responsibilities is the task of developing legislative recommendations. These recommendations customarily center on improving and simplifying the Title IV programs, minimizing administrative costs and improving program integrity. Our recommendations inform the Department's policymaking process, including its activities and decisions related to the reauthorization of the Higher Education Act. Federal Student Aid will continue to identify new business processes and procedures, innovative system solutions, best-practice risk management approaches and ground-breaking contracting solutions that help reduce the cost of administering the Title IV programs as well as limit the vulnerability of the Title IV programs to fraud, waste, abuse and mismanagement. We will also continue

to identify, propose and implement improvements to the personnel and procurement flexibilities afforded us in our PBO legislation.

Federal Student Aid will continue to propose legislative and regulatory recommendations to the Department of Education's Office of Postsecondary Education based on the knowledge we gain from our business operations and our interactions with students, parents, schools, lenders, guaranty agencies and other program participants. In our statutory, regulatory or policy recommendations, we will focus on proposed changes that simplify the application process for students and streamline the processes and operations for schools and delivery partners.

POSSIBLE FUTURE EFFECTS OF EXISTING EVENTS AND CONDITIONS

Federal Student Aid's ability to fully implement the initiatives described in this report are impacted by external factors including budget and policy considerations and unanticipated events. Federal Student Aid works closely with the Department and Office of Management and Budget to develop our administrative budget and ensure appropriate resources are allocated to support our strategic objectives.

Legislative and/or regulatory action may result in policy, resources or program changes requiring Federal Student Aid to revisit our current strategic plan. Specifically, the reauthorization of the Higher Education Act is scheduled to occur during this session of Congress. Once completed, Federal Student Aid will revise both our *Annual Performance Plan* and the *Five-Year Plan* to meet the new legislative and/or regulatory requirements.

Other external factors could also affect our ability to achieve the organization's objectives. For example, in August and September 2005, hurricanes Katrina and Rita caused extensive damage to the Gulf Coast region of the United States. As a result, Federal Student Aid mounted a large-scale response effort to assist our customers impacted by the unprecedented destruction of hurricanes Katrina and Rita. This response includes:

- outreach and assistance to impacted schools and students;
- outreach to FFEL lenders, servicers, guaranty agencies, and borrowers;
- creation of specialized units within Federal Student Aid customer call centers;
- creation of specialized toll-free phone numbers;
- creation of a consolidated source Web site to provide guidance and communications to our customers concerning issues related to hurricanes Katrina and Rita;
- creation of a special e-mail address and mailbox for submission of questions; and
- issuance of Federal Student Aid guidance and policy related to issues impacting students, parents, schools, financial institutions, guaranty agencies and borrowers.

Federal Student Aid is committed to assisting our students and their families, schools and partners impacted by the storms.



FY 2005 Annual Report Appendices

Appendix A **FY 2005 Tactical Accomplishments**

| FY 05 PROJECT NUMBER | ACTION ITEMS | ACCOMPLISHMENTS | Strategic Objectives | | | | | Operational Responsibilities | Status of Pending Items (Completed items are shaded.) |
|----------------------|---|--|--|-------------------------------|-----------------|--------------------------------------|-----------------------------------|------------------------------|--|
| | | | 1- FSA Systems Integration and Technology Solution Initiatives | 2 - Improve Program Integrity | 3 - Reduce Cost | 4 - Improve Human Capital Management | 5 - Improve Products and Services | | |
| ANNUAL ACTIVITIES | | | | | | | | | |
| 1.1 | Implement student aid awareness initiatives. | | | | | | X | X | |
| | | Leveraged partnership arrangements with organizations to participate in activities to disseminate Federal Student Aid (FSA) information. | | | | | | | |
| | | Published accurate and timely information that meets the needs of our audiences. | | | | | | | |
| | | Disseminated information directly to target audience through FSA participation in outreach activities. | | | | | | | |
| | | Responded accurately and timely to customer requests managed by Editorial Services Contractor. | | | | | | | |
| | | Reached customers through Student Aid on the Web and FSA for Counselors and Mentors Site. | | | | | | | |
| 1.2 | Implement application products and customer services. | | | | | | X | X | 90% complete. See below. |
| | | Developed a process for student data trends and customer feedback analysis with the end goal of sharing findings across interrelated functional areas and serving students (and their influencers) more effectively. | | | | | | | Carried over to the 2006 Performance Plan. |
| | | Developed an enhanced requirements tracking process as it relates to student-facing products and services. | | | | | | | |
| 1.3 | Improve customer interaction through customer feedback. | | | | | | X | X | 90% complete. See below. |
| | | Monitored customer feedback particularly at the Customer Service Call Center (CSCC) to improve services. | | | | | | | |
| | | Monitored customer feedback for Common Originations and Disbursement (COD). | | | | | | | |
| | | Monitored customer feedback for FAFSA On The Web (FOTW). | | | | | | | Carried over to the 2006 Performance Plan. |
| | | Monitored customer feedback for Student Aid On The Web (SAOTW). | | | | | | | |



| FY 05 PROJECT NUMBER | ACTION ITEMS | ACCOMPLISHMENTS | Strategic Objectives | | | | | Operational Responsibilities | Status of Pending Items (Completed items are shaded.) |
|----------------------|--|---|--|-------------------------------|-----------------|--------------------------------------|-----------------------------------|------------------------------|--|
| | | | 1- FSA Systems Integration and Technology Solution Initiatives | 2 - Improve Program Integrity | 3 - Reduce Cost | 4 - Improve Human Capital Management | 5 - Improve Products and Services | | |
| ANNUAL ACTIVITIES | | | | | | | | | |
| | | Monitored customer feedback for FSA Information Center (FSAIC). | | | | | | | |
| | | Provided Enterprise-wide services for FSA--translation, document design, web design, printing and fulfillment. | | | | | | | |
| 1.4 | Conduct application processing [Central Processing System (CPS), FOTW, PIN Site, FAA Access, Participation Management (PM) and the Institutional Student Information Record (ISIR) Data Mart]. | | | X | | | X | X | 80% complete. See below. |
| | | Implemented CPS application. | | | | | | | |
| | | Improved the effectiveness of verification by conducting IRS statistical studies to evaluate the effectiveness of FSA's verification selection process and criteria, implement identified improvements and estimate 2004-05 Pell Grant erroneous payment amounts (over- and under-awards) | | | | | | | Carried over to the 2006 Performance Plan. |
| | | Developed and implement the process to notify applicants who estimated income, of the need to update their tax data. | | | | | | | |
| 1.5 | Provide EDExpress application modules. | | | | | | | X | |
| | | Released Application, Global and Packaging modules. | | | | | | | |
| | | Released Common Origination & Disbursement module. | | | | | | | |
| 1.6 | Administer Pell Grant and Direct Loan activities. | | | X | | | | X | |
| | | Issued COD software release. | | | | | | | |
| | | Set Pell Grant initial authorization levels for upcoming Award Year by Jun 1st. | | | | | | | |
| | | Issued Pell Grant ACA payments to schools at least two times during an Award Year. | | | | | | | |
| | | Ceased acceptance of Pell Grant Award Year data after Sep 30th of Award Year unless school is granted Administrative Relief. | | | | | | | |
| | | Performed monthly (Pell Ops) reconciliation of obligations between feeder system and Education Central Automated Processing System (EDCAPS) within 15 business days of end of month. | | | | | | | |

| FY 05 PROJECT NUMBER | ACTION ITEMS | ACCOMPLISHMENTS | Strategic Objectives | | | | | Operational Responsibilities | Status of Pending Items (Completed items are shaded.) |
|----------------------|--|---|--|-------------------------------|-----------------|--------------------------------------|-----------------------------------|------------------------------|---|
| | | | 1- FSA Systems Integration and Technology Solution Initiatives | 2 - Improve Program Integrity | 3 - Reduce Cost | 4 - Improve Human Capital Management | 5 - Improve Products and Services | | |
| ANNUAL ACTIVITIES | | | | | | | | | |
| | | Compared Pell Grant School Drawdown with Net Accepted and Posted Disbursements in COD for 30-day reporting compliance. | | | | | | | |
| | | Closed out applicable Direct Loan Program Year by Jul 31 of the calendar year. | | | | | | | |
| | | Defined procedures to cease acceptance of Direct Loan award data based on each school's latest loan period end date in a given program year. In the case of a school with borrower-based academic year loans, define process and procedures to prevent an extended closeout date due to a relatively minor (to be defined) number of borrower-based academic year loans. | | | | | | | |
| 1.7 | Administer Campus-Based activities. | | | | | | | X | 88% complete. See below. |
| | | Published annual Campus-Based combined Federal Register notice that provides Award Year deadline dates to schools. | | | | | | | |
| | | Issued final awards to schools. | | | | | | | |
| | | Issued Fiscal Operations Report and Application to Participate (FISAP) Report software release. | | | | | | | |
| | | Developed and implement procedures for notifying and terminating eligibility in the Perkins Loan program when an institution's cohort default rate exceeds 50% for three consecutive years with appropriate business/owner input/approval. [Policy Liaison and Implementation (PLI), Campus-Based, Default Management, Common Services for Borrowers (CSB), FSA's School Eligibility Channel (SEC), etc.) | | | | | | | Carried over to the 2006 Performance Plan. |
| 1.8 | Upgrade Postsecondary Education Participation System (PEPS). | | | | | | | X | Cancelled - Integrated into Action Item 11.6 Integrated Partner Management (IPM). |
| 1.9 | Enhance program monitoring and oversight. | | | X | X | | X | | |
| | | Administered the Quality Assurance program by developing a web-based Institutional Student Information Report (ISIR) analysis tool. | | | | | | | |



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|----------------------|--------------|---|--|-------------------------------|-----------------|--------------------------------------|-----------------------------------|------------------------------|--|
| | | | 1- FSA Systems Integration and Technology Solution Initiatives | 2 - Improve Program Integrity | 3 - Reduce Cost | 4 - Improve Human Capital Management | 5 - Improve Products and Services | | |
| ANNUAL ACTIVITIES | | | | | | | | | |
| | | Developed and implement case management procedures to increase national consistency of case team operations. | | | | | | | |
| | | Developed and begin implementation of a training plan to communicate national standards to the School Participation Teams. | | | | | | | |
| | | Developed and implement a Consistency Panel to increase consistency of School Participation Team operations, broaden understanding of case management procedures, and provide input to refine national standards. | | | | | | | |
| | | Developed and begin implementation of a quality control process for School Participation Teams to improve their consistency in implementing case management procedures and national standards. | | | | | | | |
| | | Conducted the current compliance initiative project, and use results to improve program operations. | | | | | | | |
| | | Conducted the Experimental Sites initiative. | | | | | | | |
| | | Administered the Quality Assurance program by delivering tools and training. | | | | | | | |
| | | Successful implemented special projects to address the specific Title IV needs of institutions identified by the President's Special Initiatives. | | | | | | | |
| | | Improved program integrity through reduction of default rates. | | | | | | | |
| | | Processed school compliance audits to support on-going oversight and program monitoring. | | | | | | | |
| | | Developed and implement procedures for escalating operational issues for appropriate oversight action. | | | | | | | |

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| ANNUAL ACTIVITIES | | | | | | | | | |
| 1.10 | Produce school publications and materials and electronically notify schools of new publications within one business week of posting on the Information for Aid Professionals (IFAP) including Direct Loan publications. | | | X | | | X | | |
| | | Increased the number of IFAP subscribers by 10% above the 2004 volume of 5,486 subscribers. | | | | | | | |
| | | Tracked number of inquiries received by CSCC by reviewed the CSCC tracking system on a quarterly basis in order to understand what information institutions need that could be incorporated into subsequent FSA Handbooks or recommended to the Policy Liaison Implementation staff for development of additional guidance. | | | | | | | |
| | | Fulfilled orders for Direct Loan Program publications at the fulfillment center within 72 hours of receipt 90% of time, notwithstanding back orders. | | | | | | | |
| 1.11 | Develop and deliver program and technical training for schools through a combination of videoconferences, web-based training, and classroom experiences. | | | X | | | X | | |
| 1.12 | Restructure integration leadership support to transition the majority of responsibility to FSA staff. | | X | | X | X | | | |
| 1.13 | Implement specific improvements based on Vulnerability Assessment produced in FY 04. | | | X | | | | X | |
| | | Implemented enhanced controls to monitor possible misuse of PIN. | | | | | | | |
| | | Strengthened oversight activities for targeted schools. | | | | | | | |
| 1.14 | Develop and enhance inclusive Application, School Eligibility and Delivery Services (ASEDS) requirements-tracking process that includes the input of all FSA clients. | | | X | | | X | X | |
| 1.15 | Develop, load, and maintain an enterprise inclusive business process modeling system. | | X | | X | X | | X | |
| 2.1 | Enhance program monitoring and oversight. | | | X | X | | X | X | |
| | | Developed the Lifetime Default rate for the Direct Loan and the Federal Family Education Loan (FFEL) programs based on the date the borrower entered repayment. | | | | | | | |
| | | Determined the impact of forbearance and deferment on the borrower and the taxpayer for the Direct Loan and FFEL programs. | | | | | | | |



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| | | Developed and implement a process/metrics to identify, track and compare FFEL delinquency rates to Direct Loan delinquency rates. | | | | | | | |
| | | Continued IV&V monthly vulnerability assessments throughout Phase 1 and Phase 2 of the CSB implementation. | | | | | | | |
| 2.2 | Implement plan to improve customer service to the Direct Loan portfolio and increase participation in e-servicing. | | | | X | | X | X | |
| 2.3 | Assure accuracy of Direct Loan Consolidations Loan Summary Statement sent to borrowers. | | | | X | | X | X | |
| 2.4 | Implement the Common Services for Borrowers system. | | X | | X | | X | | 99.8% complete. See below. |
| | | Retired Credit Management Data Mart (CMDM). | | | | | | | |
| | | Completed a FSA/CSB Panagon Training Plan and Manual and complete first round of training (Phase 1A). | | | | | | | |
| | | Incorporated the Direct Loan Consolidation functionality into the CSB website. | | | | | | | Carried over to the 2007 Performance Plan. |
| | | Completed Phase I CSB Data Mart (Phase 1A). | | | | | | | |
| | | Migrated the Direct Loan Consolidation System to the CSB (Phase IB). <i>[Actual start date was Aug 1, 2004.]</i> | | | | | | | |
| | | Continue to migrate the Direct Loan Servicing System to the CSB Platform. <i>(Actual start date was Aug 1, 2004.)</i> | | | | | | | Cancelled - Replaced in 2006 Performance Plan. See Action Item 11.28. |
| | | Retired the legacy Direct Loan Consolidation System to CSB (Phase IB). | | | | | | | Cancelled - CSB will deliver new Loan Consolidation System in 2007. |
| 2.5 | Establish recovery rate targets for all FSA default collections utilizing all recovery tools. | | | X | X | | X | | |

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| 2.6 | Establish recovery rate targets for all FSA default collections less consolidation. | | | X | X | | X | | |
| 2.7 | Establish recovery rate targets on combined FSA & Guaranty Agency (GA) default collections. | | | X | X | | X | | |
| 2.8 | Maintain consistent or improved recovery levels during task order transition. | | | X | X | | X | | |
| 2.9 | Control growth of FSA defaulted loan portfolio. | | | X | X | | X | | 80% complete. Carried over to the 2006 Performance Plan. |
| 2.10 | Evaluate Borrower Services current alignments. | | | X | X | | X | X | 98% complete. See below. |
| | | Identified and assigned the monitoring responsibility for the sixty-nine CSB performance metrics. | | | | | | | |
| | | Monitored Direct Loan Consolidation operational transition to CSB environment. | | | | | | | Carried over to the 2006 Performance Plan. |
| | | Completed alignment of bankruptcy, entitlement, financial and loan processing functions to support Borrower Services integrated systems and services. | | | | | | | |
| | | Developed a responsibility matrix for processing activities including a performance review schedule and mentoring schedule. | | | | | | | |
| | | Developed the Non-Default Portfolio Team responsibility matrix, performance review schedule and mentoring schedule. | | | | | | | |
| 2.11 | Negotiate and obtain internal contractor for Earned Value (EV) data. | | | | | | X | X | |
| 2.12 | Develop Spanish language forms for FFEL Program comparable to those that were developed for the Direct Loan Program and posted to the FSA website. | | | | | | X | | |
| 3.1 | Perform National Student Loan Data System (NSLDS) maintenance and operations activities. | | | X | X | | X | X | |
| | | Reviewed, evaluated, and prepared data provider monthly benchmark reports. | | | | | | | |
| | | Calculated quarterly GA fee calculations and send to the Financial Management System (FMS). | | | | | | | |



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| | | Participated in pre-calculation coordination efforts, calculate draft by Feb 15, and official cohort default rates by Sep 30; electronically send the school rates and post to the website. | | | | | | | |
| | | Provided monitoring functionality of GA reasonability on a monthly basis. | | | | | | | |
| | | Evaluated the NSLDS Vulnerability Assessment produced in FY 04 to determine which findings can be dealt with via the existing NSLDS operations support vehicle versus a new task order effort. Those findings to be dealt with via the existing NSLDS operations support vehicle will be addressed and implemented. | | | | | | | |
| 3.2 | Perform maintenance and operation activities for the Financial Partners (FP) Data Mart. | | | X | | X | X | X | |
| | | Developed and implemented a Consolidated Lender/Service Scorecard so that all pertinent data for lenders, including that which was submitted by servicers, is provided for all lenders. | | | | | | | |
| | | Monitored data mart feeds to provide accurate, concise and timely data to users. Prepared tracking reports depicting data load activities on a monthly basis. Reports will be available five business days after close of the month. | | | | | | | |
| 3.3 | Perform operations activities for the Financial Partners (FP) Portal. | | | | | X | X | X | |
| | | Obtained/evaluated feedback from financial partners' user community on value of information posted on the FP Portal. | | | | | | | |
| | | Monitored and evaluated web page hits to determine the usefulness of web content so we maintain the most pertinent current information and develop applicable future content. Reports depicting monthly activity will begin five business days after the close of the month. | | | | | | | |

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| | | Enhanced the usage of the Financial Partner Portal by posting additional information that is associated with Financial Partner activities. | | | | | | | |
| 3.4 | Perform Leveraging Educational Assistance Partnership/ Special Leveraging Educational Assistance Partnership (LEAP/SLEAP) activities. | | | X | X | | X | X | |
| | | Reviewed, evaluated, reconciled, and prepared performance reports for Award Year 2004. | | | | | | | |
| | | Prepared and submitted clearance paperwork for publication of the Award Year 2005 Deadline Dates Notice. | | | | | | | |
| | | Reviewed and approved applications from states. Obligated, generated, and mailed grant award notifications to states for Award Year 2005. | | | | | | | |
| 3.5 | Perform Voluntary Flexible Agreement (VFA) activities. | | | X | X | | X | X | |
| | | Evaluated new applications for a VFA and provide a final decision and notification on each proposal. | | | | | | | |
| | | Exploited existing system capabilities to automate the collection of data used within the benchmark reports. Prepared quarterly performance measure assessment and benchmarking reports beginning Jan 2005. | | | | | | | |
| 3.6 | Perform Exceptional Performer (EP) activities. | | | X | | | X | X | |
| | | Evaluated and completely processed new EP applications in 60 days or less from the date of receipt. | | | | | | | |
| | | Monitored performance of approved EPs, ensuring that all program reviews are completed by the end of FY05, and that all deficiencies are addressed in a timely manner. | | | | | | | |
| 3.7 | Enhance program monitoring and oversight. | | | X | X | X | X | X | |



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| ANNUAL ACTIVITIES | | | | | | | | | |
| | | Performed program reviews of GAs and lenders/servicers. Prepared quarterly summary reports detailing issues, corrective actions and future monitoring and oversight activities. Reports will be available 15 days after the close of the month. Use the report information to develop review plans for FY 06. | | | | | | | |
| | | Monitored the Federal Reserve Ratios for GAs. Implemented management plans for GAs whose reserve ratios drop below the minimum threshold that appear to be in financial difficulty based on FP Services assessment of various factors. | | | | | | | |
| | | Prepared the legislatively mandated report to Congress on GA Fiscal Soundness. | | | | | | | |
| | | Performed cohort default rates analyses and provide technical assistance. Prepare default rate guide, notification letters and materials for distribution and posting of draft (GAs only) and official (GA and Lender) cohort default rates. Coordinate the press release and summary of national cohort default rate data with Default Management Division (Schools). | | | | | | | |
| | | Utilized GA/lender scorecards to reduce risk and improve review process. | | | | | | | |
| | | Performed analysis of Federal Fund data and calculate Federal Reserve Ratios for all GAs. | | | | | | | |
| | | Participate and provide support for ED's FY 05 annual financial statement audit to ensure all Financial Partners' prepared by client (PBC) items are addressed. | | | | | | | |
| | | Monitor GA program review findings associated with Form 2000. | | | | | | | |
| | | Review and revise, as appropriate, the Form 2000 annual instructions to comply with CFO and FP Services reporting requirements. Assist CFO in revising the Monthly/Quarterly instructions. | | | | | | | |

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| ANNUAL ACTIVITIES | | | | | | | | | |
| | | Analyzed, reviewed and approved Form 2000, Annual Report submissions for accuracy and to ensure compliance and consistency of reporting by GAs. | | | | | | | |
| | | Monitored and reviewed GA and Lender annual compliance audits. Reviewed and resolved OIG audits. | | | | | | | |
| | | Evaluated, resolved, settled and/or negotiated financial matters related to federal assets of guaranty agencies such as commercial real property, business, equipment, and software. | | | | | | | |
| 4.1 | Manage Financial Management System (FMS) operations. | | | X | | | X | X | |
| 4.2 | Sustain clean audit opinion and address material weaknesses and reportable conditions identified in annual financial statement audits. | | | X | | | X | X | |
| | | Sustained and improved timely reconciliations and implement other procedures needed to comply with accelerated reporting requirements. | | | | | | | |
| | | Coordinated with program offices to deliver high-quality PBC items on a timely basis. | | | | | | | |
| | | Reviewed Credit Reform estimates. | | | | | | | |
| 4.3 | Manage system internal control review processes. | | | X | | | X | X | 90% complete. Carried over to the 2006 Performance Plan. |
| 4.4 | Manage activity-based costing program. | | | | X | | X | X | |
| 4.5 | Administer a budget reporting schedule to provide management and FSA budget staff with a comprehensive package of budget information to facilitate decision making and fund management. | | | | X | | X | | |
| 4.6 | Provide CSB implementation team with requirements/information/guidance in a timely manner. | | | X | X | | X | X | |
| 4.7 | Improve reconciling the discrepancies in Monthly Forms 2000 when comparing GAs to FMS. | | | X | X | | X | X | |
| 4.8 | Support timely and accurate disbursements to operating partners: guaranty agencies, lenders, and schools. | | | X | X | | X | X | |



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| ANNUAL ACTIVITIES | | | | | | | | | |
| 5.1 | Provide Enterprise and Data Architecture management. | | X | X | X | | | | |
| | | Adopted a coordinated EA Governance Process that effectively aligns technology decisions to FSA's business needs, the IPC and the IT lifecycle management processes. | | | | | | | |
| | | Adopted proven IT components and standards for enterprise reporting, data modeling and capture of capital planning information for input into the eCPIC tool and OMB documentation. | | | | | | | |
| | | Demonstrated alignment of FSA EA with the Department's EA as part of the EA governance process. | | | | | | | |
| 5.2 | Provide security and privacy support. | | | X | | | X | | |
| | | Created and deliver a System Security Officers' Certification training course. | | | | | | | |
| | | Completed risk assessment on systems that use the FSA PIN for authentication. | | | | | | | |
| | | Created detailed implementation plan for an FSA enterprise vulnerability/patch management solution. | | | | | | | |
| | | Documented FSA security program's current state and future vision. | | | | | | | |
| 5.3 | Provide Integrated Technical Architecture (ITA) and Enterprise Architecture Integration (EAI) maintenance and production support. | | | X | | | X | | |
| | | Provided production support for ITA and EAI tools, products, and services. | | | | | | | |
| | | Provided architecture maintenance support for ITA and EAI tools, products, and services. | | | | | | | |
| | | Provided enterprise performance testing environments and support to project teams. | | | | | | | |

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| 5.4 | Support the FSA IT assets at the Virtual Data Center (VDC) with lines of service including, full and incremental backups, annual disaster recovery tests, disaster recovery location and services, quarterly capacity planning, annual penetration testing, test environment support, security, compliance to all appropriate FSA, Department, & federal policies, regulations, statutes. | | | | X | | X | | |
| | | Developed a plan for the continuity of VDC services after the current contract expires. | | | | | | | |
| | | Reduced VDC processing cost (by 10% from '04 baseline of \$60 mil) by Sep 30, 2005. Ongoing costs will be compared to budgeted reductions on a monthly basis. | | | | | | | |
| | | Conducted surveys of VDC customers. The VDC aims for a participation level of 50% with 90% or higher reporting satisfaction with VDC operations. | | | | | | | |
| | | Performed activities, such as ongoing scanning and compliance reviews, to maintain VDC Certification and Acceptance (C&A) for FY 05. | | | | | | | |
| | | Performed a majority of activities necessary to recomplete VDC <i>(Actual completion date is 12/9/05).</i> | | | | | | | |
| 5.5 | Continue Enterprise QA Program to support the FSA CIO in conducting systems assessments and evaluations consistent with best practices for Solution Life Cycle and the CPIC processes. | | | X | | | X | | |
| | | Provided IV&V support to four core FSA development efforts: EAI / ITA, CSB, FMS, and Electronic Records Management (ERM) Operations support. | | | | | | | |
| | | Implemented PIR process and procedures as required by Clinger-Cohen and the Department's Strategic Goal Six for a minimum of two initiatives. | | | | | | | |
| | | Developed baseline methodology for QA program metrics. | | | | | | | |
| 5.6 | Support the Department's customers and business partners by participating in the President's Management Agenda's (PMA) E-Government initiatives. | | X | X | | | X | | |



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| | | Provided overall project management for the eLoans initiative and transition plan, including supporting HUD's completion of the Risk Management BPI study and potential Citizen Access to CAIVRS / Sharing Lender Performance Data prototypes. | | | | | | | |
| | | Participated in E-Authentication government-wide initiative, including completing the FSA systems E-Authentication Assurance Level Assessments by Dec 15, 2004 and the Department and GSA MOU by Mar 31, 2005. | | | | | | | |
| | | Participated in GovBenefits government-wide team by supporting completion of the Phase II Strategic Plan. | | | | | | | |
| | | Participated in eVital government-wide team and support action items as developed by the team. | | | | | | | |
| 5.7 | Validate the Data Quality Management Plan. | | X | | | | | | |
| 5.8 | Manage the Holistic Extensible Markup Language (XML) Management Plan. | | X | | | | | | |
| 6.1 | Plan and manage FSA conferences. | | | X | | | X | X | |
| 6.2 | Plan and implement a new conference planning/delivery procurement. | | | | X | | | | |
| 6.3 | Manage, develop and update content for FSANet (FSA's Intranet) | | | | X | X | | X | 90% complete. Carried over to the 2006 Performance Plan. |
| 6.4 | Manage controlled correspondence functions including Freedom of Information Act (FOIA), privacy and controlled mail. | | | X | | | | X | |
| 6.5 | Develop and implement internal and external communications strategy. | | | X | X | X | X | X | |
| 7.1 | Evaluate current project management processes, procedures and tools and begin standardizing practices, where applicable. | | | | | | | X | |
| 7.2 | Standardize acquisition processes by developing standard policies, procedures and tools. | | | X | X | X | X | X | 95% complete. See below. |
| | | Communicated proper procedures for FSA's acquisition function. | | | | | | | |

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| ANNUAL ACTIVITIES | | | | | | | | | |
| | | Redesigned acquisition websites. | | | | | | | |
| | | Maintained an enterprise acquisition plan that includes all of the elements needed to assist FSA in conducting its mission. | | | | | | | |
| | | Services are provided at the right place at the right time, legally and in a cost effective manner. | | | | | | | Carried over to the 2006 Performance Plan. |
| | | Improved enterprise contractor performance management processes within FSA. | | | | | | | |
| | | Maintained internal controls and monitor government property accountability. | | | | | | | |
| 7.3 | Continually monitor and report on accomplishments related to the high-risk areas and to recommendations in GAO's 2004 high-risk review. | | | X | X | X | X | X | |
| 7.4 | Establish FSA's Enterprise Risk Management Group (ERMG) to enhance risk management activities and internal review capabilities across FSA to support the Department's Enterprise Risk Management Committee. The team will identify concentrations of risk throughout the organization and recommend appropriate actions to address these risks. Tasks will be added here along with their metrics as they are identified throughout the year. | | | X | | | X | X | 95% complete. Carried over to the 2006 Performance Plan. |
| 7.5 | Develop/implement strategies and plans for identifying, assessing, monitoring and reporting on risk, analyzing data, and conducting internal reviews throughout the organization. | | | X | | | X | X | |
| 7.6 | Maintain close ties with GAO and OIG, facilitate their audit activities and assist FSA management in addressing significant issues from those activities in a timely and effective manner. | | | X | | | X | X | |
| 7.7 | Submit final FY 04 Annual Performance Report to Congress. | | | | | | | X | |
| 7.8 | Update FSA's Five-Year Performance Plan. | | | | | | | X | |
| 7.9 | Develop FY06 Annual Performance Plan. | | | | | | | X | |
| 7.10 | Issue customer satisfaction survey results. | | | | | | X | | |
| 7.11 | Execute reporting for FSA's Annual Performance Plan, the Department's Performance and Accountability Report (PAR) and the PMA. | | | | | | | X | |
| 7.12 | Perform the audit reporting and audit liaison functional responsibilities for all of FSA. | | | X | | | | X | |



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| 8.1 | Provide high quality information, research and informal problem resolution services to student loan borrowers and other participants in student aid programs. | | X | | | X | | | |
| 9.1 | Conduct activities related to legislation such as the Reauthorization of the Higher Education Act (HEA), budget and appropriations bills that affect federal student aid. | | X | X | | X | X | | |
| 9.2 | Prepare for FSA/IRS data match. | | X | X | | X | | | |
| 9.3 | Conduct activities related to required submissions to OMB. | | X | X | | X | X | | |
| 9.4 | Provide statutory, regulatory and other policy advice, leadership and expertise to FSA management and staff. | | X | | X | X | X | | |
| 9.5 | Perform professional liaison activities among OPE, OGC and FSA regarding student aid issues. | | X | X | | X | X | | |
| 9.6 | Develop and/or participate in the development of various internal and external FSA communications. | | | X | | | X | | |
| 9.7 | Advise the Offices of Postsecondary Education (OPE), the General Counsel (OGC), Legislative and Congressional Affairs (OLCA) and other ED and OMB offices of the impact of proposed legislative, regulatory, or policy initiatives to the federal student aid programs. | | X | X | | X | X | | |
| 10.1 | Human Capital Plan: "Integrate Human Capital into Strategic Planning and Daily Operations." | | | | X | | | 90% complete as of 9/30/05. Actual completion date 12/31/05. | |
| 10.2 | Human Capital Plan: "Develop Current and Future Leaders." | | | X | X | | | | |
| 10.3 | Human Capital Plan: "Strengthen Our Results-Oriented Culture - Ensure Managers Effectively Motivate and Manage Employees." | | | X | X | X | | | |
| 10.4 | Human Capital Plan: "Ensure the Right People are in the Right Jobs to Deliver the Right Aid to the Right Students at the Right Time in the Right Way." | | X | X | X | X | | 90% complete. See below. | |
| | | Implemented Intern Program. | | | | | | | |
| | | Conducted New Employee Orientation. | | | | | | | |
| | | Launched FSA Front to Back on the Web. | | | | | | | |
| | | Provided employee FSA University courses through the Career Zone. | | | | | | | |

| FY 05 PROJECT NUMBER | ACTION ITEMS | ACCOMPLISHMENTS | Strategic Objectives | | | | | Operational Responsibilities | Status of Pending Items (Completed items are shaded.) |
|----------------------|---|---|--|-------------------------------|-----------------|--------------------------------------|-----------------------------------|------------------------------|--|
| | | | 1- FSA Systems Integration and Technology Solution Initiatives | 2 - Improve Program Integrity | 3 - Reduce Cost | 4 - Improve Human Capital Management | 5 - Improve Products and Services | | |
| ANNUAL ACTIVITIES | | | | | | | | | |
| | | Increased the accessibility of FSA Skills Catalog. | | | | | | | Projected completion date of 3/31/06 for survey of usefulness of the catalog. |
| | | Administered Learning Coupon program. | | | | | | | |
| | | Provided "End to End" Student Aid Business Knowledge Learning Track. | | | | | | | |
| | | Provided employee individual development courses through the Career Zone. | | | | | | | |
| 10.5 | Perform facilities management activities. | | | X | X | X | X | X | |
| | | Coordinated security needs. | | | | | | | |
| | | Coordinated the distribution of the Transit Benefit program. | | | | | | | |
| | | Ensured facility needs are met. | | | | | | | |
| | | Coordinated FSA Emergency Preparedness. | | | | | | | |
| 11.1 | Support the implementation of Oracle Federal Financials Release 11i. | | X | X | | | X | X | Cancelled - Replaced with Action Item 11.16. |
| 11.2 | Develop project plan in conjunction with Ollie deadlines (FY 05 - FY 07); also, develop user requirements and establish teams to track account balances at the institution, GA and lender entity level. | | X | X | | | X | | Cancelled - Replaced with Action Item 11.16. |
| 11.3 | Implement the ADvance Solution. | | X | X | X | | X | X | |
| | | Announced ADvance Contract Award. | | | | | | | |
| | | Assembled FSA/vendor transition team. | | | | | | | |
| | | Determined high-level transition schedule. | | | | | | | |
| | | Determined high-level design and implementation schedule. | | | | | | | |
| 11.4 | Implement FSA Integrated Enterprise Communications (FSAIEC). | | X | | | | X | | 95% complete. Project launch delayed due to hurricane-related activities. Carried over to the 2006 Performance Plan. |
| 11.5 | Deploy Enterprise Security Architecture infrastructure. | | X | X | | | | X | |
| | | Procured Hardware Resources. | | | | | | | |
| | | Procured Software Licenses. | | | | | | | |
| | | Configured Software. | | | | | | | |
| 11.6 | Implement the Integrated Partner Management (IPM) Solution. | | X | X | | | X | X | |



| FY 05 PROJECT NUMBER | ACTION ITEMS | ACCOMPLISHMENTS | Strategic Objectives | | | | | Operational Responsibilities | Status of Pending Items (Completed items are shaded.) |
|----------------------|--|--|--|-------------------------------|-----------------|--------------------------------------|-----------------------------------|------------------------------|--|
| | | | 1- FSA Systems Integration and Technology Solution Initiatives | 2 - Improve Program Integrity | 3 - Reduce Cost | 4 - Improve Human Capital Management | 5 - Improve Products and Services | | |
| ANNUAL ACTIVITIES | | | | | | | | | |
| | | Completed High-Level Conceptual Design and phased sequencing plan. | | | | | | | |
| | | Procured contract for Phase 1. | | | | | | | |
| 11.7 | Develop Common Data Architecture (CDA) Strategy. | | X | X | X | | X | X | |
| | | Completed the first version of the FSA Enterprise Data Model and CDA Conceptual Design. | | | | | | | |
| | | Developed high-level CDA Sequencing Plan for implementation (<i>Actual Start Date 8/15/04</i>). | | | | | | | |
| | | Continued to develop and maintain FSA's Data Architecture in the data and enterprise modeling tool. | | | | | | | |
| | | Completed the majority of work necessary in order to prepare a high-level cost estimate on CDA 1.0 (<i>Completion Oct 31, 2005</i>). | | | | | | | Cancelled - Integrated into Information Framework and Student Aid History Management solution (see below). |
| | | Completed the majority of work necessary to develop the governance processes needed to begin a CDA (Completion Oct 31, 2005). | | | | | | | Cancelled - Integrated into Information Framework and Student Aid History Management solution (see below). |
| | | Began developing Statement of Objectives to procure Student Aid History Management (SAHM) and Information Framework solution | | | | | | | |
| | | Completed update to FSA Target State Vision diagram & narrative documentation. | | | | | | | |
| 11.8 | Implement National Student Loan Data System (NSLDS) enhancements. | | | X | | | X | X | |
| 11.9 | Initiate School Eligibility Channel (SEC) process improvements. | | X | X | | | X | X | |
| 11.10 | Support application testing in an Integrated Technical Architecture (ITA)/Enterprise Architecture Integration (EAI) Environment. | | | | | | | X | |
| 11.11 | Procure enterprise software licenses for evaluation and deployment. | | X | | | | | X | |
| 11.12 | Implement Enterprise Change Management. | | X | X | X | | X | X | |
| | | Performed tool implementation and prototype solution. | | | | | | | Cancelled - Replaced in 2006 Performance Plan with Action Item 11.32. |
| 11.13 | Establish Quantitative and Qualitative (Q&Q) Cost library. | | | X | X | | X | | Cancelled - Replaced in 2006 Performance Plan with Action Item 11.12. |

| FY 05 PROJECT NUMBER | ACTION ITEMS | ACCOMPLISHMENTS | Strategic Objectives | | | | | Operational Responsibilities | Status of Pending Items (Completed items are shaded.) |
|----------------------|--|---|--|-------------------------------|-----------------|--------------------------------------|-----------------------------------|------------------------------|--|
| | | | 1- FSA Systems Integration and Technology Solution Initiatives | 2 - Improve Program Integrity | 3 - Reduce Cost | 4 - Improve Human Capital Management | 5 - Improve Products and Services | | |
| ANNUAL ACTIVITIES | | | | | | | | | |
| 11.14 | Begin work on NSLDS Re-engineering (Effort will depend upon Data Strategy Sequencing and available funding). | | X | X | X | X | X | | Cancelled - Integrated into Student Aid History Management initiative. See Action Item 11.7. |
| | | Began analysis and gathering initial requirements to determine needed NSLDS task orders for FY 05. | | | | | | | Cancelled - Integrated into Student Aid History Management initiative. See Action Item 11.7. |
| | | Performed all necessary steps for contract acquisition project. | | | | | | | Cancelled - Integrated into Student Aid History Management initiative. See Action Item 11.7. |
| | | After contract was awarded, began analysis and gathering business requirements for NSLDS conceptual design. | | | | | | | Cancelled - Integrated into Student Aid History Management initiative. See Action Item 11.7. |
| 11.15 | Defense Contract Audit Agency (DCAA) Support. | | | X | X | | X | | |
| 11.16 | Support Reimplementation of FMSS as Oracle Federal Financials | | | X | X | | X | | |







FY 2005 Annual Report Appendices

Appendix B **Annual Financial Report**

I am pleased to report that for the fourth consecutive year, Federal Student Aid has received an unqualified opinion on our consolidated financial statements. This opinion demonstrates Federal Student Aid's commitment to the highest standards of management, financial responsibility and program integrity. For the third consecutive year, the auditors identified no material weaknesses.

Federal Student Aid had an exceptional year. The recent removal of our programs from the Government Accountability Office (GAO) High-Risk List was a significant accomplishment and the result of considerable efforts expended to strengthen our financial condition and improve the integrity of the student aid programs.

Through the efforts and teamwork of Federal Student Aid management and staff as well as the cooperative efforts of the Office of Inspector General (OIG) and the independent auditors, we continued to make progress on two previous reportable conditions: credit reform estimation and controls surrounding information systems. During the next fiscal year, we are committed to building on the improvements made during fiscal year 2005 in these two areas. At the same time, while improvements were made in implementing Certification and Accreditation initiatives during fiscal year 2005, we will continue to strengthen the controls over information technology processes.

In addition to our removal from the GAO High Risk List, we also:

- ◆ Contributed to the Department of Education's "green light" status on the President's Management Agenda (PMA) initiative, *Improving Financial Performance*, and enabled Federal Student Aid to move to a "green light" for the progress in the PMA initiative, *Eliminating Improper Payments*;
- ◆ Were instrumental in effectively identifying, developing, and analyzing supplemental funding proposals for those impacted by Hurricanes Katrina and Rita, to ensure continued education.

Looking forward, Federal Student Aid is committed to issuing its new Statement of Assurance on Internal Controls, in compliance with Office of Management and Budget Circular A-123, *Management Accountability and Control*, in fiscal year 2006. We look forward to working with the OIG and our auditors to ensure Federal Student Aid's continued commitment to superior business practices and our success in meeting the goals and objectives of the Performance Based Organization legislation.

Message from the Chief Financial Officer



A handwritten signature in blue ink, which appears to be "VB", written over a horizontal line.

Victoria L. Bateman
Chief Financial Officer

November 9, 2005

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Section I

Management's Discussion and Analysis

Management Discussion and Analysis

Scope, Mission and Organizational Structure

Federal Student Aid, an office of the U.S. Department of Education, ensures that all eligible Americans can benefit from federally funded or federally guaranteed financial assistance for education beyond high school. We consistently champion the promise of postsecondary education to all Americans—and its value to our society.

The *Management Discussion and Analysis* provides a brief overview of Federal Student Aid's mission and organizational structure; performance goals objectives, and results; financial statements; and systems, controls and legal compliance. It also allows readers to assess Federal Student Aid's performance relative to our mission, strategic goals and objectives, and the stewardship of the resources entrusted to the organization and our programs.

Mission and Organizational Structure

To fulfill our mission, Federal Student Aid partners with postsecondary schools and financial institutions to deliver programs and services that help students finance their education beyond high school. We play a central and essential role in the American community of postsecondary education. Today the organization processes millions of student applications; disburses funds to students through schools; enforces financial aid rules and regulations; partners with schools and financial institutions to prevent waste, fraud and abuse; educates students and families about the process of obtaining aid; services millions of student loan accounts; and operates information technology systems and tools that manage billions in student aid dollars. This is a complex, multifaceted mission that calls on a range of staff skills, and demands management coordination at a high level.

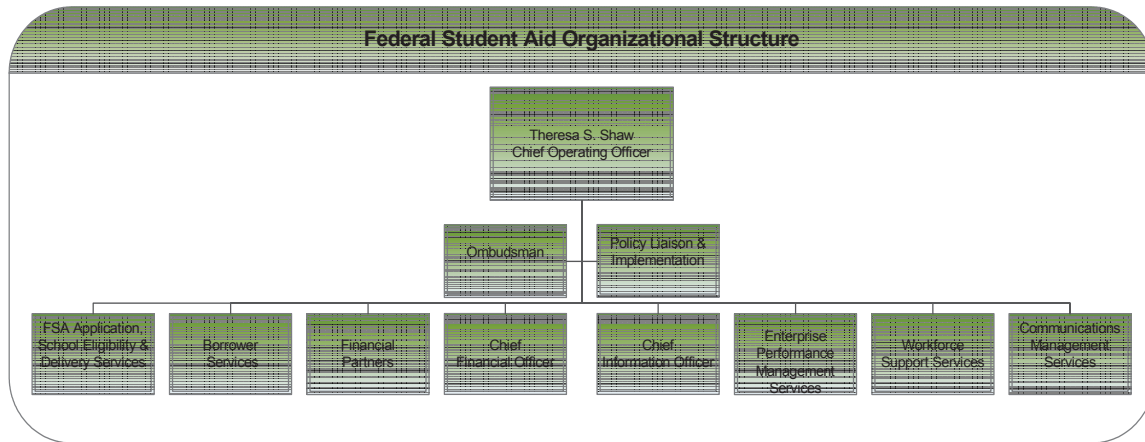
Designated a Performance-Based Organization (PBO) by Congress in 1998, Federal Student Aid emphasizes tangible results and efficient performance, as well as the continuous improvement of the processes and systems that support our mission.

Organization

Since 2003, Federal Student Aid has operated under an improved functional structure that aligns our organization more closely with our true strategic drivers, business objectives, and mission goals. The new structure reinforces a key business goal: efficient and productive interaction with our many stakeholders. This community of stakeholders is far ranging, including students and parents, schools, and lenders and guaranty agencies, as well as other Federal entities and the Department of Education (Department) itself. The rationale for our organizational structure is high performance – specifically, demonstrated mission results at levels of efficiency that minimize risk and maximize return on the government's investment in Federal Student Aid's operations. The graphic below illustrates this improved structure.

Management Discussion and Analysis

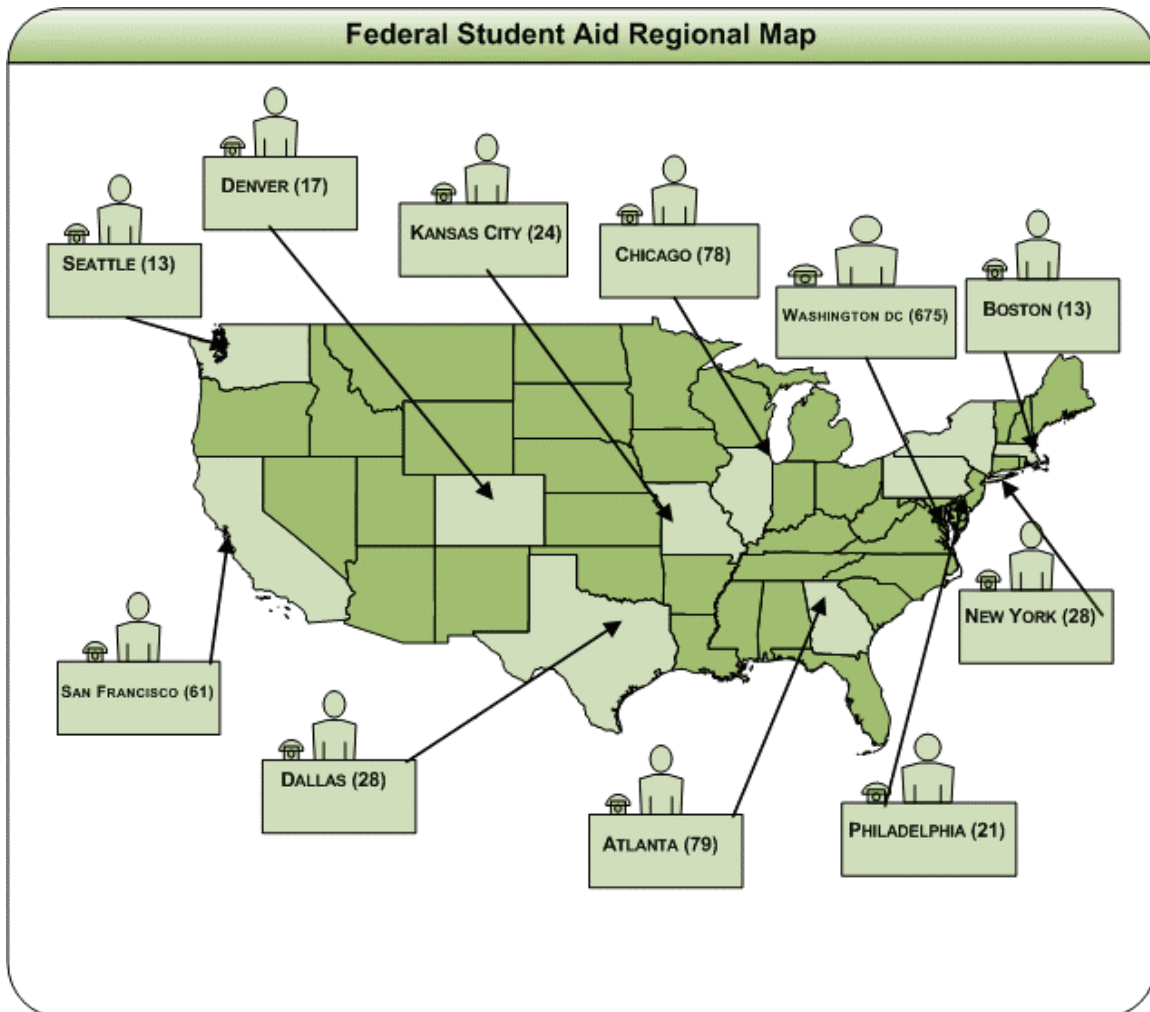
Scope, Mission and Organizational Structure



Chief Operating Officer (COO) Theresa S. Shaw, who was appointed to a five-year term by the Secretary of Education in 2002, leads Federal Student Aid. In fiscal year 2005, the organization operated on an annual administrative budget of \$631 million. Our staff of nearly 1,050 is augmented by contractors who provide outsourced business operations. This workforce is based at locations throughout the country, including ten regional offices in addition to the Washington, DC headquarters. The map below highlights the locations of Federal Student Aid regional offices by city and state, and the number of Federal Student Aid employees based at each location, indicated in parentheses.

Management Discussion and Analysis

Scope, Mission and Organizational Structure



As a federally designated PBO, Federal Student Aid operates under a Congressional mandate to achieve concrete mission results as it improves efficiency in performance. Federal Student Aid has focused on innovations for upgrading student aid delivery and servicing operations, vendor and contract management, budgeting and cost control, and financial and operational management. Much of the resulting performance improvement will stem from business process re-engineering and large-scale technology integration.

Programs

Federal Student Aid is responsible for helping students manage the costs of education beyond high school. This duty includes administering the U.S. government postsecondary student financial assistance programs authorized under Title IV of the Higher Education Act (HEA) of 1965, as amended (Title IV). Title IV programs collectively represent the nation's largest source of financial aid for postsecondary students. The following paragraphs briefly describe each of the major Title IV programs that deliver federal aid to students and their families.

Management Discussion and Analysis

Scope, Mission and Organizational Structure

The **Federal Pell Grant (Pell Grant) Program** helps ensure financial access to postsecondary education by providing grant aid to low and middle-income undergraduate students. The most need-focused of the Department's student aid programs, Pell Grant awards, vary in proportion to the financial circumstances of students and their families. For the 2004-2005 award year, the Department disbursed \$13.1 billion in Pell Grants averaging \$2,469 to 5.3 million students. The maximum Pell Grant award amount remained at \$4,050 for the 2004-2005 award year.

The **Federal Supplemental Educational Opportunity Grant (FSEOG)**, the **Federal Work Study (FWS)**, and the **Federal Perkins Loan Programs (Perkins)** are three **campus-based** formula grant programs where the Department provides funds directly to eligible institutions, enabling them to provide grants, employment, and low interest loans on the basis of student needs. For the 2004-2005 award year, the Department disbursed approximately 3 million campus-based awards, totaling \$3.3 billion.

There are two **state formula grant** programs. The **Leveraging Educational Assistance Partnership (LEAP) Program**, authorized by Section 415A of the HEA of 1965, as amended, makes federal funds available to assist states in providing student assistance programs for students with substantial financial need. The **Special Leveraging Educational Assistance Partnership (SLEAP) Program** was added to the LEAP Program in the 1998 Amendments to the HEA (Section 415E). SLEAP makes federal funds available to states to cover a third of the cost of supplementing their LEAP Program, supplementing their LEAP Community Service Work-Study programs, and/or providing Merit and Academic Achievement, or Critical Careers Scholarships to students with substantial financial need.

Two major guaranteed student loan programs account for nearly all of the remainder of the Department's financial assistance for postsecondary education. Loans can either be subsidized, where the government pays the interest while the student is in school and during qualified periods of grace and deferment, or unsubsidized.

The **Direct Loan Program** lends funds through participating schools directly to students. The Department borrows these funds from the U.S. Treasury. Details on borrowings and interest on those borrowings are contained in the disclosures in Notes 6 and 12 to the Principal Financial Statements. In fiscal year 2005, the Department awarded \$12.8 billion¹ in net loans to 1.9 million Direct Loan Program recipients. The average subsidized Direct Loan was \$3,750, while the average unsubsidized loan was \$5,222.

Funds for the **Federal Family Education Loan (FFEL) Program** are provided by private lenders and are insured by loan guaranty agencies and reinsured by the

¹ Excludes consolidation loans of \$17.7 billion.

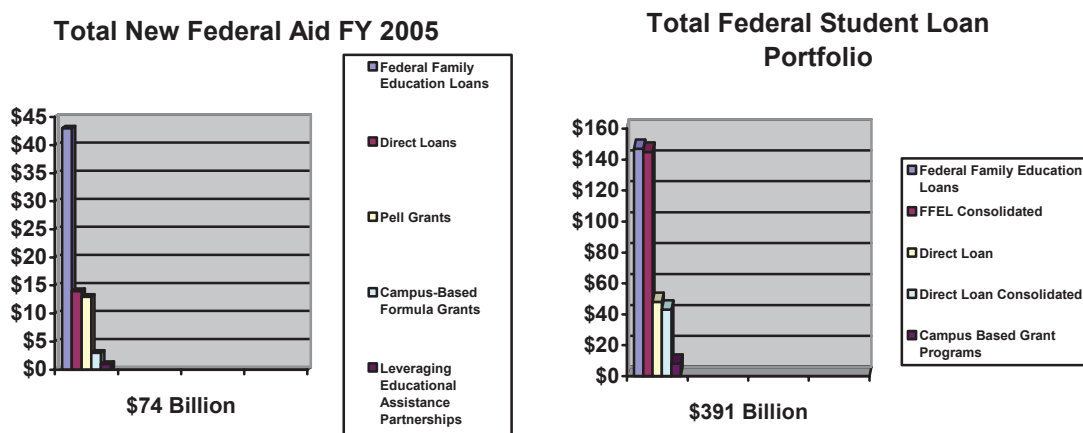
Management Discussion and Analysis

Scope, Mission and Organizational Structure

federal government. During fiscal year 2005, the Department facilitated the delivery of \$43 billion² in net loans to 5.8 million FFEL recipients. The average subsidized FFEL loan was \$3,465, while the average unsubsidized loan was \$4,980. In addition, Federal Student Aid paid an estimated \$5.1 billion to lenders for interest and special allowance subsidies, and an estimated \$4 billion to guaranty agencies to reimburse them for defaulted FFEL loans, and loan processing, issuance, and account maintenance fees required by the HEA.

In 2005, Federal Student Aid delivered or facilitated the delivery of approximately \$74 billion in federal aid to approximately 10 million postsecondary students and their families. Federal Student Aid interacts with approximately 6,100 schools, approximately 3,200 lenders, 35 guaranty agencies, dozens of accrediting agencies, as well as secondary markets, third-party servicers and other organizations.

In fulfilling our program responsibilities, Federal Student Aid directly manages or oversees more than \$391 billion in outstanding loans representing almost 80 million student loans to over 26 million borrowers. The graphic below illustrates the fiscal scope of Federal Student Aid's operations in fiscal year (FY) 2005.



² Excludes estimated consolidation loans of \$50.8 billion.

Performance Goals, Objectives, and Results

Federal Student Aid has realized considerable progress in administering student aid programs since the organization became the federal government's first PBO in 1998. Federal Student Aid recognizes the importance of a long-term strategic plan to guide our efforts, to improve our oversight and administration of student aid programs and to fulfill our mission as a PBO.

The following strategic drivers influence Federal Student Aid's long-term goals and objectives:

- The President's Management Agenda
- The Government Accountability Office (GAO) High-Risk List
- PBO legislation
- The Department's Strategic Plan
- Customer needs.

To more effectively manage the organization's programs and provide clear strategic direction to all internal and external constituencies, Federal Student Aid's COO and senior leadership team identified the following five strategic objectives to guide the organization:

1. Integrate Federal Student Aid systems and provide new technology solutions to deliver federal student aid in an efficient and cost-effective manner;
2. Improve program integrity to ensure access to postsecondary education while reducing vulnerability to fraud, waste and abuse;
3. Reduce program administration costs to improve control over resources and maintain accountability for results;
4. Improve human capital management; and
5. Improve products and services to provide better customer service.³

Key Performance Goals and Results

The following paragraphs summarize Federal Student Aid's 2005 achievements.

³ A sixth objective, *Deliver Student Aid Effectively and Accurately*, was added to Federal Student Aid's Annual Performance Plan to facilitate reporting on the performance of day-to-day operational activities. Although the sixth objective was reported in the 2004 Annual Report and MD&A, it is an operational performance goal, not a strategic objective. Accordingly, it will continue to be part of Federal Student Aid's Annual Performance Plan but it will not be separately addressed as a strategic objective in future reports.

Strategic Objective One: Integrate Systems and Provide New Technology Solutions

- Completed several system and business process integration initiatives as part of a multi-year, integration-sequencing plan:
 - o Awarded the ADvance contract, an initiative to modernize and integrate the organization's core front-end business functions through the re-engineering, retirement and replacement of existing legacy aid delivery systems. Formerly called the Front-End Business Integration initiative, the ADvance solution creates a fully integrated aid application, Pell Grant and Direct Loan origination and disbursement system that consolidates and streamlines common functions and offers an end-to-end, online view of financial aid information for customer service representatives, schools and students. Once fully implemented in fiscal year 2008, the ADvance system is expected to save taxpayers \$500 million over the life of the contract.
 - o Continued implementation of the Common Services for Borrowers initiative; a solution that consolidated FSA's back-office systems for Direct Loan Servicing, Consolidation, and Collections into a single integrated solution projected to save \$1 billion over the life of the contract.

Strategic Objective Two: Improve Program Integrity

- Federal Student Aid has institutionalized sound financial management and internal controls at every level in the organization.
 - o Accomplished FSA's top program integrity priority with removal of Federal Student Aid programs from the Government Accountability Office's High-Risk list after 14 years of being on that list.
 - o Contributed to the Department of Education's achievement of "green light" for the status rating on the President's Management Agenda (PMA) initiative, *Improving Financial Performance* initiative and enabled FSA to move to a "green light " for the progress rating on the PMA initiative, *Eliminating Improper Payments*.
 - o Achieved a new historic low rate of 4.5 percent for the National Cohort Default Rate (NCDR) for fiscal year 2003, a reduction of 13.5 percent from the fiscal year 2002 rate of 5.2 percent.
 - o Achieved our fourth consecutive unqualified audit opinion in fiscal year 2005.

Strategic Objective Three: Reduce Program Costs

- Decreased the unit administrative cost of delivering student aid programs through efficiency and productivity gains in our business processes. These gains allow Federal Student Aid to successfully manage dramatically increasing workloads.
- o Improved management and control of operating expenses through efficiencies, productivity gain, and capital savings. FSA's fiscal year 2006 operating expense budget has been reduced to 47 percent of the total budget versus 54 percent of the total budget in 2000. Over the same period, FAFSA applications have increased by almost 40 percent, the dollar volume of loans has grown by 84 percent, unduplicated borrowers have increased 55 percent, and the number of loans has increased by 63 percent.
- o Established fiscal years 2003 and 2004 unit-cost measures based on actual expenditures and performance measurement data. Using these measures we were able to (1) project unit costs for fiscal years 2005 through 2009, and (2) support projections in our fiscal year 2007 budget submission.
- o Reduced collection costs by 30 percent since 1997 while increasing default collections by over 240 percent. In fiscal year 2005, Federal Student Aid renegotiated our private collection agency contracts further reducing the cost to collect by 13 percent over the next three years and projecting an additional 25 percent increase in default collections over the same period.

Strategic Objective Four: Improve Human Capital Management

- Continued to develop a work environment that encourages high performance and promotes professional growth to ensure Federal Student Aid attracts and retains a skilled, knowledgeable and motivated workforce:
- o Improved succession-planning capabilities by identifying areas within the organization where subject-matter expertise needs strengthening due to the pending retirement of senior employees.
- o Achieved significant progress in performance management by clearly differentiating among performance levels and the delivery of real results.

Strategic Objective Five: Improve Customer Service

- Improved service to customers through process re-engineering, innovation and improvement and by increasing customer awareness, access and self-service;

Management Discussion and Analysis

Performance Goals, Objectives, and Results

- o Scored in the “Excellent” and “Good” range of the fiscal year 2005 American Customer Satisfaction Index (ACSI) ratings for Federal Student Aid’s highest volume products and services – including Direct Loan Servicing, *FAFSA on the Web*, the Common Origination and Disbursement system and the Lender Reporting System. Federal Student Aid products score higher than the federal government aggregate and on par with private sector organizations such as UPS, Amazon.com and financial services companies such as JP Morgan Chase, Bank of America and Wells Fargo.
- o Launched a multi-year enterprise communications strategy in fiscal year 2005 to better articulate the benefits of postsecondary education, raise awareness of federal student aid programs and improve consistency across all communications to our many stakeholders, including currently underserved communities. In addition, this strategy establishes partnerships with organizations at national, regional and local levels that have the common goal of promoting awareness of and access to aid for postsecondary education.

Additionally, Federal Student Aid continues to respond to our customers impacted by the unprecedented destruction of Hurricanes Katrina and Rita. This response includes:

- outreach and assistance to impacted schools and students;
- outreach to FFEL lenders, servicers, guaranty agencies, and borrowers;
- creation of specialized units within Federal Student Aid customer call centers;
- creation of specialized toll-free phone numbers;
- creation of a consolidated source Web site to provide guidance and communications to our customers concerning issues related to Hurricane Katrina;
- creation of a special email address and mailbox for submission of questions; and
- issuance of Federal Student Aid guidance and policy related to issues impacting students, parents, schools, financial institutions, guaranty agencies and borrowers.

Reliability of Performance Data

Comprehensive performance management is critical to ensuring that aid is delivered effectively and accurately. Planning and reporting activities include:

Federal Student Aid’s **Five-Year Strategic Plan** is a statement of strategic direction articulating the organization’s long-term objectives. In addition to

Management Discussion and Analysis

Performance Goals, Objectives, and Results

providing Federal Student Aid's strategic guidance, the Five-Year Strategic Plan establishes performance standards for measuring the organization's success.

Federal Student Aid's **Annual Performance Plan** establishes specific tactical initiatives to achieve each of the organization's strategic objectives outlined in the Five-Year Strategic Plan. Timelines, milestones and status are tracked in the Annual Performance Plan and evaluated on a bi-monthly basis to ensure their alignment with current business needs, the allocation of resources, the availability and allocation of capital and operating funds, policy considerations, statutory and regulatory requirements.

Detailed annual performance results including the organization's audited financial statements are provided in Federal Student Aid's **Annual Performance Report**. These three documents form the foundation of Federal Student Aid's strategic planning, tactical implementation and reporting processes.

Additionally, Federal Student Aid continues to improve the systems and procedures used to identify, budget, select, monitor, and improve operations. Performance monitoring includes weekly project planning and reporting activities detailing the scope, schedule, cost, quality and overall status of key initiatives. The unit-cost model provides cost identification, control and management. The Federal Student Aid Dashboard tracks and reports enterprise-wide performance metrics. Human capital performance metrics are reported separately in the Human Capital Dashboard.

Performance Reporting Limitations and Difficulties

The underlying assumptions in Federal Student Aid's performance planning and reporting processes are based on current budgetary, operational, and policy considerations. External events beyond our control can impact these underlying assumptions, potentially impacting the organization's ability to plan, meet and report upon its objectives. As necessary, Federal Student Aid reevaluates and revises its performance planning and reporting processes to adapt to these external factors.

Financial Statements and Stewardship Information

Federal Student Aid is committed to providing sound management, financial systems and controls to ensure that students receive aid according to applicable laws and regulations. Federal Student Aid's financial statements are prepared in conformance with accounting principles generally accepted in the United States. Federal Student Aid financial statements are subject to an annual independent audit to ensure that they are reliable and fairly present our financial position.

In fiscal year 2005, Federal Student Aid achieved a fourth consecutive unqualified audit opinion on our financial statements. The Independent Auditor's Report cited no material weaknesses in internal controls. This sustained achievement was critical to Federal Student Aid's removal in fiscal year 2005 from GAO's High-Risk List and is the result of substantial improvements to internal controls, continued improvement in our accounting and financial processes, and Federal Student Aid's strategic planning and financial reporting.

For fiscal years 2004 and 2005, the Balance Sheet, Statement of Net Cost, Statement of Changes in Net Position, and Statement of Financing were prepared on a consolidated basis and our Statement of Budgetary Resources was prepared on a combined basis as required by OMB Circular A-136, *Financial Reporting Requirements*. The Report of Independent Auditors (opinion) on these statements and accompanying Reports on Internal Control and Compliance with Laws and Regulations are included in this report.

For the FFEL and Direct Loan programs, appropriations are available to cover the subsidy cost of each program as well as administrative expenses. Subsidy expenses are the net present value of future cash flows. The Pell Grant program receives one appropriation that covers actual grant disbursements. Appropriation authority is available as needed on a permanent basis to finance operations resulting from loans guaranteed in the years before fiscal year 1992.

Federal Student Aid's principal financial statements are the:

- (1) Balance Sheet
- (2) Statement of Net Cost
- (3) Statement of Changes in Net Position
- (4) Statement of Budgetary Resources
- (5) Statement of Financing

A comparison between significant line items reported in Federal Student Aid's fiscal years 2005 and 2004 is presented in the following table.

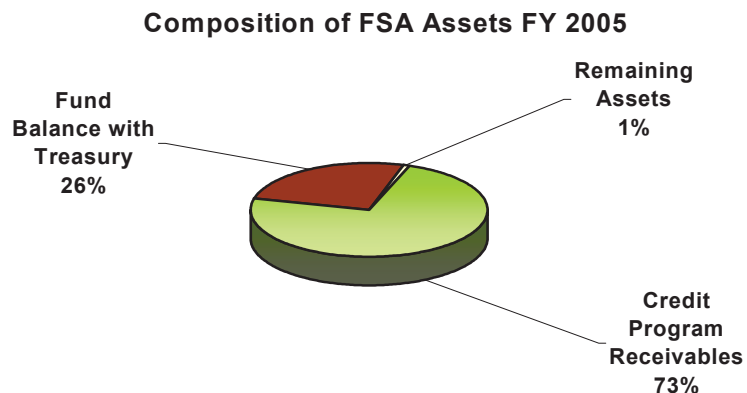
Management Discussion and Analysis
Analysis of Financial Statements and Stewardship Information

| Summarized Financial Data | | | |
|---------------------------|-------------------|------------------|------------------|
| (Dollars in Millions) | | | |
| | Percentage Change | Fiscal Year 2005 | Fiscal Year 2004 |
| Total Assets | 10% | \$146,505 | \$133,188 |
| Total Liabilities | 12% | \$142,455 | \$127,069 |
| Net Position | -34% | \$4,050 | \$6,119 |
| Net Cost of Operations | 32% | \$31,162 | \$23,666 |

The Balance Sheet

Composition of Federal Student Aid Assets

The Consolidated Balance Sheet shows Federal Student Aid had total assets of nearly \$147 billion at the end of fiscal year 2005. This represents an increase of approximately \$14 billion over the previous year's total assets of \$133 billion. The difference is primarily the result of a \$10.5 billion approximate increase in Fund Balance with Treasury and the growth of Credit Program Receivables. The increase in Fund Balance with Treasury is primarily the result of the receipt of FFEL Program subsidy appropriations that will fund future costs of guaranteed loans. The increase in Credit Program Receivables is the result of increased number of student borrowers and the amounts borrowed.



Credit Program Receivables and Fund Balance with Treasury have steadily increased. Credit Program Receivables are comprised primarily of principal and interest amounts owed by students for Direct Loans and defaulted guaranteed loans under the FFEL program. As of September 30, 2005, there was \$107.6 billion in Credit Program Receivables, the majority of which were Direct Loan program receivables of \$95.7 billion, and FFEL Credit Program Receivables of \$11.7 billion.

Management Discussion and Analysis

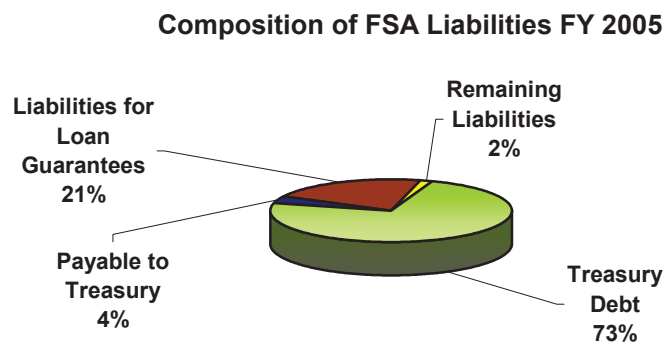
Analysis of Financial Statements and Stewardship Information

Fund Balance with Treasury represents Federal Student Aid's funds available to make authorized expenditures and finance loan programs. The Treasury processes Federal Student Aid's cash receipts, such as warrants that provide cash for operations and loan payment collections received from students. The Treasury also processes operating expenditures and other disbursements on behalf of Federal Student Aid.

The remaining assets include Accounts Receivable, Cash and Other Monetary Assets, General Property, Plant, and Equipment, and Other Assets.

Composition of Federal Student Aid Liabilities

Federal Student Aid has total liabilities for fiscal year 2005 of \$142 billion. Most of Federal Student Aid liabilities consist of Treasury debt, which represents the balance due Treasury for previous borrowings used to fund disbursements of Direct Loans to students. The Treasury Debt of \$104.4 billion is for the Direct Loan program.



Treasury Debt and Liabilities for Loan Guarantees have increased steadily. Treasury Debt, which showed increased activity in fiscal year 2005, is the amount borrowed from and owed to the Treasury to fund Direct Loans to students. The Liabilities for Loan Guarantees under FFEL are the estimated costs on a present-value basis of the net long-term cash outflows resulting from loan defaults and interest supplements that are offset by fees. Loan guarantees encourage private lenders to provide student education loans. The increase was the result of a re-estimate of the FFEL subsidy expense and current year activity in backing any losses to the lenders. The Payable to Treasury balance is the amount owed for downward subsidy re-estimates and for amounts that will be returned to Treasury after all pre-1992 loan guarantees have been satisfied. The remaining liabilities include Accounts Payable, Guaranty Agency Federal and Restricted Funds Due to Treasury, Accrued Grant Liability, Federal Employee and Veterans Benefits and Other Liabilities.

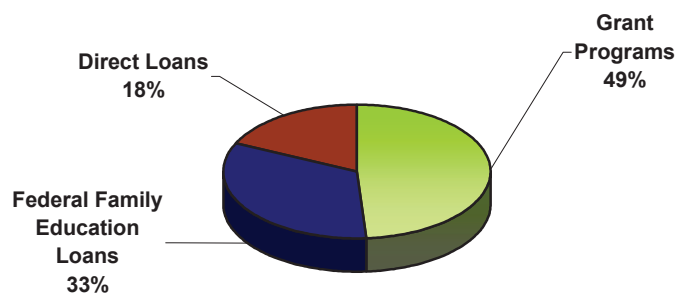
Statement of Changes in Net Position

Federal Student Aid's Net Position as of September 30, 2005 is \$4.1 billion, which decreased by \$2 billion, compared to \$6.1 billion for September 30, 2004. The change was the result of a net increase in unfunded subsidy re-estimates for the FFEL and Direct Loan programs, and a lower balance of undisbursed Pell Grants as of fiscal year end 2005.

Statement of Net Cost

Federal Student Aid had total net costs of \$31.2 billion during fiscal year 2005. In the FFEL program, the total net cost was \$10.3 billion. In the Direct Loan Program, total net costs were \$5.6 billion. The grant programs had a total net cost of \$15.3 billion. The net cost with the public is primarily composed of subsidy expenses and the funding of grants. Subsidy expenses are the estimated costs of funding the direct loans and loan guarantees. The amount of the subsidy expense equals the present value of estimated cash outflows over the life of the loans minus the present value of estimated cash inflows. Indirect costs are Departmental administrative costs including supplies, training costs, rent/lease agreements, mail services, and other costs allocated to each Federal Student Aid program as part of our effort to report full cost.

Composition of FSA Net Cost FY 2005



Statement of Budgetary Resources

The Statement of Budgetary Resources compares the budgetary resources provided with the status or execution of those resources and shows the amount of net outlays. This statement shows that Federal Student Aid had \$108.1 billion in combined budgetary resources of which \$24.2 billion remained unobligated and not available at year-end. Federal Student Aid had total net outlays for fiscal year 2005 of \$25.8 billion.

Statement of Financing

The Statement of Financing demonstrates the relationship between an entity's proprietary and budgetary accounting information by linking the net cost of operations (proprietary) with net obligations (budgetary) through the identification of key differences between the two statements. The statement identifies \$28.3 billion of resources used to finance Federal Student Aid activities.

Systems, Controls, and Legal Compliance

The following section describes the actions Federal Student Aid is taking to improve financial integrity and accountability. Federal Student Aid is also providing updates on compliance with legal requirements.

Internal Controls

Effective internal controls are essential to programmatic and financial integrity and accountability in order to prevent waste, fraud and abuse. Program managers assess the Federal Student Aid management control environment throughout the year for adequacy of management control systems. Below are the highlights of financial management improvements implemented by Federal Student Aid during fiscal year 2005.

Federal Student Aid is working with the Department to support a Department-wide assurance statement on the effectiveness of internal controls over financial reporting as of June 30, 2006, with any remediation activities noted through September 30, 2006. The Federal Student Aid COO is a member of the Department-wide Senior Management Council and the Federal Student Aid Chief Financial Officer and senior staff are members of the Department-wide Senior Assessment Team charged with planning and conducting work and making a recommendation to the Secretary on the effectiveness of internal controls over financial reporting at the Department level.

As of fiscal year-end 2005, Federal Student Aid is in the planning and documentation phases of our internal OMB Circular A-123 compliance and internal control assessment program. Federal Student Aid is in the process of appointing full-time dedicated resources to manage A-123 compliance activities and has issued a solicitation for contract support. These Federal Student Aid resources will plan internal compliance activities, conduct internal risk assessments, document organizational and process hierarchies, document Federal Student Aid's control libraries, assess the effectiveness of Federal Student Aid controls over financial reporting, coordinate remediation activities and retesting, and report on status and results internally. Federal Student Aid plans to implement an automated compliance solution in a development environment at the virtual data center early in fiscal year 2006.

The Federal Managers' Financial Integrity Act (FMFIA), Sections 2 and 4, Management Control and Financial Management Systems

The FMFIA requires the Secretary to report annually to the President and Congress regarding the adequacy of the Department's internal controls and financial management systems. In fiscal year 2003, through the implementation

of corrective action plans developed by program managers, the Department determined that previously identified material weaknesses were no longer considered material. Federal Student Aid did not identify any new material weaknesses under FMFIA during fiscal year 2005.

Possible Future Effects of Existing Events and Conditions

Federal Student Aid's ability to fully implement the initiatives described in this plan are impacted by external factors including budget and policy considerations and unanticipated events. Federal Student Aid works closely with the Department and OMB to develop our administrative budget and ensure appropriate resources are allocated for our strategic objectives. The external factors below could affect our ability to achieve the organization's objectives.

Legislative and/or regulatory action may result in policy, resources, or program changes requiring Federal Student Aid to revisit our current strategic plan. Specifically, the reauthorization of the Higher Education Act is scheduled to occur during this session of Congress. Once completed, Federal Student Aid will revise both our Annual Performance Plan and the Five-Year Strategic Plan to meet the new legislative and/or regulatory requirements.

In August and September 2005, Hurricanes Katrina and Rita caused extensive damage to the Gulf Coast Region of the United States. Federal Student Aid is committed to assisting our students and their families, schools and partners impacted by the storm. We are unable to anticipate the full cost or impact to Federal Student Aid's strategic objectives as a result of our long-term commitment to this or any other unforeseen events.

Other Management Information, Initiatives and Issues

Improper Payments Reporting

The Improper Payments Information Act of 2002 (IPIA) and the Office of Management and Budget's (OMB) implementing guidance requires agencies to annually review all programs and activities to identify those susceptible to significant improper payments. The guidance defines significant improper payments as those in any particular program that exceed both 2.5 percent of program payments and \$10 million annually. For each program identified as susceptible, agencies are required to report the annual amount of estimated improper payments, along with steps taken and actions planned to reduce them, to the President and the Congress.

To facilitate agency efforts to meet the reporting requirements of the IPIA, OMB announced a new President's Management Agenda (PMA) program initiative

beginning in the first quarter of fiscal year 2005 entitled *Eliminating Improper Payments*. Previously tracked along with other financial management activities through the *Improving Financial Performance* initiative, the establishment of a dedicated initiative focused the Department's improper payments efforts. Under the new initiative, the status and progress of actions to further identify, report on, and reduce improper payments are now tracked and reported to OMB in quarterly PMA scorecards.

FSA is working closely with OMB and OCFO in the development of an action plan designed to (1) improve the accuracy of the improper payment estimates, and (2) reduce the level of risk and the amount of known improper payments in our programs.

Limitations of the Financial Statements

The financial statements have been prepared to report the financial position and results of operations of the entity, pursuant to the requirements of 31 U.S.C. 3515(b).

While the statements have been prepared from the books and records of the entity in accordance with accounting principles generally accepted in the United States for federal entities and the formats prescribed by OMB, the statements are in addition to the financial reports used to monitor and control budgetary resources which are prepared from the same books and records.

The statements should be read with the realization that they are for a component of the U.S. Government, a sovereign entity. One implication of this is that liabilities cannot be liquidated without legislation that provides resources to do so.

Section II
Principal Financial
Statements and Notes
to Principal Financial
Statements

United States Department of Education
Federal Student Aid
Consolidated Balance Sheet
As of September 30, 2005 and 2004
(Dollars in Millions)

| | Fiscal Year 2005 | Fiscal Year 2004 |
|---|---------------------|---------------------|
| Assets: | | |
| Intragovernmental: | | |
| Fund Balance with Treasury (Note 2) | \$37,876 | \$27,343 |
| Accounts Receivable (Note 5) | | |
| Total Intragovernmental | 37,876 | 27,343 |
| Cash and Other Monetary Assets (Note 3) | 888 | 1,040 |
| Accounts Receivable, Net (Note 5) | 131 | 141 |
| Credit Program Receivables, Net (Note 4) | 107,602 | 104,612 |
| General Property, Plant and Equipment, Net | 7 | 13 |
| Other Assets | 1 | 39 |
| Total Assets | \$146,505 | \$133,188 |
| Liabilities: | | |
| Intragovernmental: | | |
| Accounts Payable | \$1 | \$3 |
| Treasury Debt (Note 6) | 104,372 | 96,421 |
| Guaranty Agency Federal and Restricted Funds Due to Treasury (Note 3) | 888 | 1,040 |
| Payable to Treasury (Note 7) | 5,166 | 4,993 |
| Other Intragovernmental Liabilities (Note 8) | 2 | 1 |
| Total Intragovernmental | 110,429 | 102,458 |
| Accounts Payable | 549 | 368 |
| Accrued Grant Liability (Note 10) | 635 | 637 |
| Liabilities for Loan Guarantees (Note 4) | 30,611 | 23,329 |
| Federal Employee and Veterans' Benefits (Note 9) | 4 | 4 |
| Other Liabilities (Note 8) | 227 | 273 |
| Total Liabilities (Note 9) | \$142,455 | \$127,069 |
| Commitments and Contingencies (Note 15) | | |
| Net Position: | | |
| Unexpended Appropriations (Note 11) | \$8,597 | \$9,181 |
| Cumulative Results of Operations (Note 11) | (4,547) | (3,062) |
| Total Net Position | \$4,050 | \$6,119 |
| Total Liabilities and Net Position | \$146,505 | \$133,188 |

The accompanying notes are an integral part of these statements.

United States Department of Education
Federal Student Aid
Consolidated Statement of Net Cost
For the Years Ended September 30, 2005 and 2004
(Dollars in Millions)

| | Fiscal Year 2005 | Fiscal Year 2004 |
|---|---------------------|---------------------|
| <i>Program Costs</i> | | |
| Program A (Enhancement of Postsecondary and Adult Education) | | |
| Intragovernmental Gross Costs | \$7,055 | \$6,307 |
| Less: Intragovernmental Earned Revenue | 2,140 | 1,626 |
| <i>Intragovernmental Net Costs</i> | 4,915 | 4,681 |
| Gross Costs with the Public | 30,952 | 23,746 |
| Less: Earned Revenues from the Public | 4,705 | 4,761 |
| <i>Net Costs with the Public</i> | 26,247 | 18,985 |
| Program A Total Net Cost | \$31,162 | \$23,666 |
| <i>Net Cost of Operations</i> | \$31,162 | \$23,666 |

The accompanying notes are an integral part of these statements.

United States Department of Education
Federal Student Aid
Consolidated Statement of Changes in Net Position
For the Years Ended September 30, 2005 and 2004
(Dollars in Millions)

| | Fiscal Year 2005 | | Fiscal Year 2004 | |
|--|--|------------------------------|--|------------------------------|
| | Cumulative Results of Operations | Unexpended Appropriations | Cumulative Results of Operations | Unexpended Appropriations |
| Beginning Balance | \$(3,062) | \$9,181 | \$(4,575) | \$9,814 |
| Budgetary Financing Sources | | | | |
| Appropriations Received | | \$31,863 | | \$27,729 |
| Other Adjustments (+/-) | (1) | (804) | | (579) |
| Appropriations Used | \$31,643 | (31,643) | \$27,783 | (27,783) |
| Nonexpenditure Financing Sources - Transfers-Out | (5) | | | |
| Other Financing Sources | | | | |
| Imputed Financing | 9 | | 10 | |
| Adjustments to Financing Sources (+/-) | (1,969) | | (2,614) | |
| Total Financing Sources | \$29,677 | \$(584) | \$25,179 | \$(633) |
| Net Cost of Operations (+/-) | \$(31,162) | | \$(23,666) | |
| Net Change | \$(1,485) | (584) | \$1,513 | \$(633) |
| Ending Balances (Note 11) | \$(4,547) | \$8,597 | \$(3,062) | \$9,181 |

The accompanying notes are an integral part of these statements.

United States Department of Education
Federal Student Aid
Combined Statement of Budgetary Resources
For the Years Ended September 30, 2005 and 2004
(Dollars in Millions)

| | Fiscal Year 2005 | | Fiscal Year 2004 | |
|---|---------------------|--|---------------------|--|
| | Budgetary | Non-Budgetary Credit Reform Financing Accounts | Budgetary | Non-Budgetary Credit Reform Financing Accounts |
| Budgetary Resources: | | | | |
| Budget Authority : | | | | |
| Appropriations Received | \$31,813 | \$1 | \$27,729 | |
| Borrowing Authority | | \$32,170 | | \$22,383 |
| Unobligated Balance: | | | | |
| Beginning of Period | 1,567 | 15,128 | 2,320 | 9,765 |
| Spending Authority From Offsetting Collections: | | | | |
| Earned | | | | |
| Collected | 3,073 | 49,510 | 5,085 | 37,679 |
| Receivable From Federal Sources | | (2) | | 4 |
| Change in Unfilled Customer Orders | | | | |
| Without advance from Federal sources | | 34 | (1) | |
| Anticipated for rest of year, without advances | | | | |
| Subtotal | \$3,073 | \$49,542 | \$5,084 | \$37,683 |
| Recoveries of Prior Year Obligations | 1,024 | 1,973 | 1,151 | 3,047 |
| Permanently Not Available | (3,507) | (24,678) | (6,135) | (18,825) |
| Total Budgetary Resources (Note 13) | \$33,970 | \$74,136 | \$30,149 | \$54,053 |
| Status of Budgetary Resources: | | | | |
| Obligations Incurred: (Note 13) | | | | |
| Direct | \$32,541 | \$51,319 | \$28,582 | \$38,925 |
| Subtotal | \$32,541 | \$51,319 | \$28,582 | \$38,925 |
| Unobligated Balance: | | | | |
| Apportioned | 31 | | 62 | 948 |
| Unobligated Balance Not Available | 1,398 | 22,817 | 1,505 | 14,180 |
| Total Status of Budgetary Resources | \$33,970 | \$74,136 | \$30,149 | \$54,053 |
| Relationship of Obligations to Outlays: | | | | |
| Obligated Balance, Net, Beginning of Period | \$9,800 | \$7,778 | \$10,332 | \$8,390 |
| Obligated Balance, Net, End of Period: | | | | |
| Accounts Receivable | | | | (2) |
| Unfilled customer orders from Federal Sources | | (34) | | |
| Undelivered Orders | 8,413 | 10,433 | 8,949 | 7,656 |
| Accounts Payable | 812 | 330 | 851 | 124 |
| Outlays: | | | | |
| Disbursements | 32,092 | 46,364 | 27,963 | 36,488 |
| Collections | (3,072) | (49,510) | (5,086) | (37,679) |
| Subtotal | \$29,020 | (\$3,146) | \$22,877 | (\$1,191) |
| Less: Offsetting Receipts | 32 | | 51 | |
| Net Outlays (Note 13) | \$28,988 | (\$3,146) | \$22,826 | (\$1,191) |

The accompanying notes are an integral part of these statements.

United States Department of Education
Federal Student Aid
Consolidated Statement of Financing
For the Years Ended September 30, 2005 and 2004
(Dollars in Millions)

| | Fiscal Year 2005 | Fiscal Year 2004 |
|---|---------------------|---------------------|
| Resources Used to Finance Activities | | |
| Budgetary Resources Obligated | | |
| Obligations Incurred (Note 13) | \$(83,860) | \$(67,507) |
| Less: Spending Authority from Offsetting Collections & Recoveries | 55,612 | 46,965 |
| Obligations Net of Offsetting Collections and Recoveries | (28,248) | (20,542) |
| Less: Offsetting Receipts | (32) | (51) |
| Net Obligations | \$(28,280) | \$(20,593) |
| Other Resources | | |
| Imputed Financing From Costs Absorbed by Others | (9) | (10) |
| Net Other Resources Used to Finance Activities | (9) | (10) |
| Total Resources Used to Finance Activities | \$(28,289) | \$(20,603) |
| Resources Used to Finance Items Not Part of Net Cost of Operations | | |
| Change in Budgetary Resources Obligated for Goods, Services and Benefits Ordered but not Yet Provided (+/-) | \$(2,608) | \$1,541 |
| Resources that Fund Expenses Recognized in Prior Period (Note 14) | (1,573) | \$255 |
| Budgetary offsetting collections and receipts that do not affect net cost of operation | 2 | |
| Credit Program Collections Which Increase/Decrease Liabilities for Loan Guarantees, or Credit Program Receivables, Net including Allowances for Subsidy | 46,853 | 35,282 |
| Resources Used to Finance the Acquisition of Fixed Assets, or Increase/Decrease Liabilities for Loan Guarantees or Credit Program Receivables, Net in the Current or Prior Period | (39,951) | (31,081) |
| Total Resources Used to Finance Items Not Part of the Net Cost of Operations | \$2,723 | \$5,997 |
| Total Resources Used to Finance the Net Cost of Operations | \$(31,012) | \$(26,600) |
| Components of the Net Cost of Operations that Will Not Require or Generate Resources in the Current Period | | |
| Components Requiring or Generating Resources in Future Periods (Note 15) | | |
| Increase in Annual Leave Liability | \$(7) | \$(7) |
| Upward/Downward Reestimates of Credit Subsidy Expense | (2,789) | \$(1,559) |
| Increase in Exchange Revenue Receivable from the Public | 1,163 | \$1,070 |
| Other (+/-) | 34 | 58 |
| Total Components of the Net Cost of Operations that Will Require or Generate Resource in Future Periods | \$(1,599) | \$(438) |
| Components Not Requiring or Generating Resources | | |
| Depreciation and Amortization | \$1,446 | \$1,805 |
| Other (+/-) (Note 14) | 3 | 1,567 |
| Total Components of the Net Cost of Operations that Will Not Require or Generate Resources | \$1,449 | \$3,372 |
| Total Components of the Net Cost of Operations that Will Not Require or Generate Resources in the Current Period | \$(150) | \$2,934 |
| Net Cost of Operations | \$(31,162) | \$(23,666) |

The accompanying notes are an integral part of these statements.

NOTES TO PRINCIPAL FINANCIAL STATEMENTS
FOR THE YEARS ENDED SEPTEMBER 30, 2005 AND 2004

Note 1. Summary of Significant Accounting Policies

Reporting Entity

Federal Student Aid (FSA) was created as a Performance Based Organization (PBO) within the U.S. Department of Education (the Department) under the *Higher Education Act of 1965*, as amended (*HEA*), from previously existing Department student financial assistance programs. FSA operates under the PBO mandate to develop a management structure driven by strong incentives to manage for results. FSA's primary goal is to assist lower-income and middle-income students in overcoming the financial barriers that make it difficult to attend and complete postsecondary education. It is responsible for administering direct loans, guaranteed loans, and grant programs.

The Federal Direct Student Loan Program (Direct Loan), authorized by the *Student Loan Reform Act of 1993*, enables FSA to make loans directly to eligible undergraduate and graduate students and their parents through participating schools. FSA borrows money from Treasury to fund the loans. The program provides interest subsidies for eligible borrowers.

The Federal Family Education Loan Program (FFEL), authorized by the *HEA*, cooperates with state and private nonprofit Guaranty Agencies to provide loan guarantees and interest subsidies on loans made by private lenders to eligible students.

The grant programs, consisting of Pell Grant and Campus-Based Student Aid Programs, enables FSA to provide educational grants and other financial assistance to eligible applicants, which are not repaid by students to the federal government. The Pell Grant Program provides grant aid to low-income and middle-income undergraduate students. Awards vary in proportion to the financial circumstances of students and their families. The Campus-Based Student Aid Programs provide educational grants and other financial assistance to eligible applicants. These programs include the Supplemental Educational Opportunity Grant, Work-Study, and Perkins Loan. Campus-Based programs are not material to these statements and have been included with other programs reported under Grants.

Basis of Accounting and Presentation

These consolidated financial statements have been prepared to report the financial position, net cost of operations, changes in net position, budgetary resources, and financing of the Federal Student Aid reporting group, in accordance with the *Chief Financial Officers Act of 1990* and the *Government Management Reform Act of 1994*. The financial statements were prepared from the books and records of FSA, in accordance with accounting principles generally accepted in the United States of America and Office of Management and Budget (OMB) Circular No. A-136 (Revised), *Financial Reporting Requirements*. Generally accepted accounting principles (GAAP) for federal entities are the standards prescribed by the Federal Accounting Standards Advisory Board (FASAB), which is the official standard setting body for the federal government. These financial statements are different from the financial reports prepared by the Department pursuant to OMB directives that are used to monitor and control FSA's use of budgetary resources.

FSA's financial statements should be read with the realization they represent the reporting group, FSA, within the Department of Education, which is itself a component of the U.S. Government, a sovereign entity. One implication of this is that liabilities cannot be liquidated without legislation providing resources and legal authority to do so.

The accounting structure of federal agencies is designed to reflect both accrual and budgetary accounting transactions. Under the accrual method of accounting, revenues are recognized when earned, and expenses are recognized when a liability is incurred, without regard to receipt or payment of cash. Budgetary accounting facilitates compliance with legal constraints and controls over the use of federal funds.

Use of Estimates

The preparation of the financial statements in accordance with accounting principles generally accepted in the United States requires management to make assumptions and estimates that directly affect the amounts reported in the financial statements. Actual results may differ from those estimates.

Estimates for credit program receivables and liabilities contain assumptions that have a significant impact on the financial statements. The primary components of this assumption set include, but are not limited to, collections (including loan consolidations), repayments, default rates, prevailing interest rates and loan volume. Actual loan volume, interest rates, cash flows and other critical components used in the estimation process may differ significantly from the assumptions made at the time the financial statements were prepared. Minor adjustments to any of these assumption components may create significant changes to the estimate.

FSA and the Department recognize the sensitivity of the changes in assumptions and the impact that the projections can have on estimates. Management has attempted to mitigate these fluctuations by using trend analysis to project future cash flows. The assumptions used for the September 30, 2005 and 2004, financial statements are based on the best information available at the time the estimate was derived.

Changes in assumptions could significantly affect the amounts reflected in these statements. For example, a long-term change in the projected interest rate charged to borrowers could change the current subsidy re-estimate by a significant amount.

The Student Loan Model (SLM) and estimating methods used are updated periodically to reflect changing conditions. The SLM was the official estimating model of the Department as of September 30, 2005 and 2004, and was used to calculate the subsidy re-estimates recorded in these financial statements.

Budget Authority

Budget authority is the authorization provided by law for the Department and FSA to incur financial obligations that will result in outlays. FSA's budgetary resources for fiscal years 2005 and 2004 included (1) unobligated balances of resources from prior years, (2) recoveries of obligations in prior years, and (3) new resources—appropriations, authority to borrow from the U.S. Department of Treasury (Treasury), and spending authority from collections. Unobligated balances associated with resources expiring at the end of the fiscal year remain available for five years after expiration only for upward adjustments of prior-year obligations, after which they are canceled and may not be used. Unobligated balances of resources that have not expired at year-end may have new obligations placed against them, as well as net upward adjustments of prior-year obligations.

Treasury Debt provides most of the funding for the loan principal disbursements made under the Federal Direct Student Loan Program. Subsidy and administrative costs of the program are funded by appropriations. Budgetary resources from collections are used primarily to repay FSA's debt to Treasury. Major sources of collections include (1) principal and interest collections from borrowers or through the consolidation of loans to borrowers, (2) related

fees, and (3) interest from Treasury on balances in certain credit accounts that make and administer loans and guarantees.

Fund Balance with Treasury

The fund balance with Treasury includes appropriated and revolving funds available to pay current liabilities and finance authorized purchases, as well as funds restricted until future appropriations are received. Treasury processes the cash receipts and cash disbursements for FSA. FSA's records are reconciled with those of Treasury. (See Note 2.)

Cash and Other Monetary Assets

Cash and other monetary assets consist of Guaranty Agency reserves and deposits in transit. Guaranty Agency reserves represent FSA's interest in the net assets of the FFEL Program Guaranty Agencies. Guaranty Agency reserves are classified as non-entity assets with the public (see Note 3) and are offset by a corresponding liability due to Treasury. Guaranty Agency reserves include initial federal start-up funds, receipts of federal reinsurance payments, insurance premiums, Guaranty Agency share of collections on defaulted loans, investment income, administrative cost allowances, and other assets purchased out of reserve funds.

Section 422A of the *HEA* required FFEL Guaranty Agencies to establish a Federal Student Loan Reserve Fund (the "Federal Fund") and an Operating Fund by December 6, 1998. The Federal Fund and the non-liquid assets developed or purchased by a Guaranty Agency as a result, in whole or in part with federal funds, are the property of the United States. However, such ownership by FSA is independent of the actual control of the assets.

FSA disburses funds to the Guaranty Agency through the Federal Fund to pay lender claims and default aversion fees of a Guaranty Agency. The Operating Fund is the property of the Guaranty Agency except for funds an agency borrows from the Federal Fund (under Section 422A of the *HEA*). The Operating Fund is used by the Guaranty Agency to fulfill its responsibilities. These responsibilities include repaying money borrowed from the Federal Fund, default aversion and collection activities.

Accounts Receivable

Accounts receivable are amounts due to FSA from the public and other federal agencies. Receivables from the public typically result from such items as disputed costs resulting from audits of educational assistance, whereas amounts due from other federal agencies result from agreements entered into by FSA with these agencies for various goods and services. Accounts receivable are recorded at cost less an allowance for uncollectible amounts. (See Note 5.)

Credit Program Receivables and Liabilities for Loan Guarantees

The financial statements at September 30, 2005 and 2004, reflect the Department's estimate of the long-term cost of direct and guaranteed loans in accordance with the *Federal Credit Reform Act of 1990*. Loans and interest receivable are valued at their gross amounts less an allowance for the present value of the amounts not expected to be recovered and thus having to be subsidized—called "allowance for subsidy." The difference is the present value of the cash flows to and from FSA that are expected from the receivables over their expected lives. Similarly, liabilities for loan guarantees are valued at the present value of the cash outflows from FSA less the present value of related inflows. The estimated present value of net long-term cash outflows of FSA for subsidized costs (primarily

defaults) is net of recoveries, interest supplements, and offsetting fees. FSA records all credit program loans and loan guarantees at their present values.

Components of subsidy costs involved with loans and guarantees include defaults, net of recoveries, contractual payments to third-party private loan collectors who receive a set percentage of amounts they collect, and, as an offset, application and other fees to be collected. For direct loans, the difference between interest rates incurred by the Department and FSA on its borrowings from Treasury and interest rates charged to target groups is also subsidized (or may provide an offset to subsidy if the Department's rate is less). The corresponding interest subsidy in loan guarantee programs is the payment of interest supplements to third-party lenders in order to buy down the interest rates on loans made by those lenders. Subsidy costs are recognized when direct loans or guaranteed loans are disbursed to borrowers and are re-estimated each year. (See Note 4.)

General Property, Plant and Equipment

In accordance with the Department's policy, FSA capitalizes single items of property and equipment with a cost of \$50,000 or more that have an estimated useful life greater than two years. Additionally, FSA capitalizes bulk purchases of property and equipment with an aggregate cost of \$500,000 or more. A bulk purchase is defined as the purchase of like items related to a specific project or the purchase of like items occurring within the same fiscal year that have an estimated useful life greater than two years. Property and equipment are depreciated over their estimated useful lives using the straight-line method of depreciation. Internal Use Software (IUS) meeting the above cost and useful life criteria is also capitalized. IUS is software purchased off the shelf, internally developed, or contractor developed solely to meet the agency's internal needs.

The Department adopted the following useful lives for the major classes of depreciable property and equipment:

| Major Classes of Depreciable Property and Equipment | Years |
|---|-------|
| Information Technology (IT), Internal Use Software (IUS) and Telecommunications equipment | 3 |
| Furniture and Fixtures | 5 |

Liabilities

Liabilities represent actual and estimated amounts likely to be paid as a result of transactions or events that have already occurred. However, no liabilities can be paid by FSA or the Department without an appropriation or other collection of revenue for services provided. Liabilities for which an appropriation has not been enacted are classified as liabilities not covered by budgetary resources, and there is no certainty the appropriation will be enacted. The government acting in its sovereign capacity can abrogate FSA and Departmental liabilities that arise from activities other than contracts. FFEL Program and Direct Loan Program liabilities are entitlements covered by permanent indefinite budget authority enacted as of year-end.

Treasury Debt

The amount shown for the liability to Treasury from borrowings represents unpaid principal owing on the loans at year-end associated with FSA's direct loan activities. FSA repays the loan principal based on available fund balances. Interest on the debt is calculated at fiscal year-end using rates set by Treasury, with such rates generally fixed based on the rate for 10-year securities. As discussed in Note 4, the interest received by FSA from borrowers will vary from the rate paid to the Treasury. Principal and interest payments are made annually. (See Note 6.)

Accrued Grant Liability

Disbursements of grant funds are recognized as expenses at the time of disbursement. However, some grant recipients incur expenditures prior to initiating a request for disbursement based on the nature of the expenditures. A liability is accrued by FSA for expenditures incurred by grantees prior to receiving grant funds for the expenditures. The amount is estimated using statistical sampling techniques. (See Note 10.)

Net Position

Net position consists of unexpended appropriations and cumulative results of operations. Unexpended appropriations include undelivered orders and unobligated balances of appropriations, except those for federal credit financing and liquidating funds. Cumulative results of operations represent the net difference since inception between (1) expenses and (2) revenues and financing sources. (See Note 11.)

Personnel Compensation and Other Employee Benefits

Annual, Sick and Other Leave. The liability for annual leave, compensatory time off, and other leave is accrued when earned and reduced when taken. Each year, the accrued annual leave account balance is adjusted to reflect current pay rates. Annual leave earned but not taken, within established limits, is funded from future financing sources. Sick leave and other types of non-vested leave are expensed as taken.

Retirement Plans and Other Retirement Benefits. Employees participate either in the Civil Service Retirement System (CSRS), a defined benefit plan, or in the Federal Employees Retirement System (FERS), a defined benefit and contribution plan. For CSRS employees, the Department contributes a fixed percentage of pay.

FERS consists of Social Security, a basic annuity plan, and the Thrift Savings Plan. The Department and the employee contribute to social security and the basic annuity plan at rates prescribed by law. In addition, the Department is required to contribute to the Thrift Savings Plan a minimum of 1 percent per year of the basic pay of employees covered by this system and to match voluntary employee contributions up to 3 percent of the employee's basic pay, and 50 percent of contributions between 3 percent and 5 percent of basic pay. For FERS employees, the Department also contributes the employer's share of Medicare.

Contributions for CSRS, FERS and other retirement benefits are insufficient to fully fund the programs, which are subsidized by the Office of Personnel Management (OPM). The Department imputes its share of the OPM subsidy, using cost factors OPM provides, and reports the full cost of the programs related to its employees.

Federal Employees Compensation Act. The *Federal Employees Compensation Act (FECA)* provides income and medical cost protection to covered federal civilian employees injured on the job, to employees who have incurred work-related occupational diseases, and to beneficiaries of employees whose deaths are attributable to job-related injuries or occupational diseases. The FECA program is administered by the U.S. Department of Labor (Labor), which pays valid claims and subsequently seeks reimbursement from the Department for these paid claims.

The FECA liability consists of two components. The first component is based on actual claims paid by Labor but not yet reimbursed by the Department. The Department reimburses Labor for the amount of actual claims as funds are appropriated for this purpose. There is generally a two-to three-year time period between payment by Labor and reimbursement to Labor by the Department. As a result, the Department recognizes a liability for the actual claims paid by Labor and to be reimbursed by the Department.

The second component is the estimated liability for future benefit payments as a result of past events. This liability includes death, disability, medical and miscellaneous costs. Labor determines this component annually, as of September 30, using a method that considers historical benefit payment patterns, wage inflation factors, medical inflation factors, and other variables. The projected annual benefit payments are discounted to present value using the Office of Management and Budget economic assumptions for 10-year Treasury notes and bonds. To provide for the effects of inflation on the liability, wage inflation factors (i.e., cost of living adjustments), and medical inflation factors (i.e., consumer price index medical adjustments) are applied to the calculation of projected future benefit payments. These factors are also used to adjust historical benefit payments and to adjust future benefit payments to current year constant dollars. A discounting formula is also used to recognize the timing of benefit payments as 13 payments per year instead of one lump sum payment per year.

Labor evaluates the estimated projections to ensure that the resulting projections were reliable. The analysis includes three tests: (1) a comparison of the percentage change in the liability amount by agency to the percentage change in the actual payments; (2) a comparison of the ratio of the estimated liability to the actual payment of the beginning year calculated for the current projection to the liability-payment ratio calculated for the prior projection; and (3) a comparison of the incremental paid losses (the medical component in particular) in congressional budget year 2005 (by injury cohort) to the average pattern observed during the prior three charge back years.

A portion of the estimated liability for disability benefits assigned to the Department under the *Federal Employees Compensation Act (FECA)* is accrued by FSA. The accrual is based on the present value of estimated net future payments by the Department of Labor, which administers the FECA program.

Intragovernmental Transactions

FSA's financial activities interact with and are dependent upon the financial activity of the centralized management functions of the federal government. FSA is subject to financial regulation and management control by the Office of Management and Budget and Treasury. As a result of this relationship, operations may not be conducted and financial positions may not be reported as they would if FSA were a separate, unrelated entity.

Note 3. Cash and Other Monetary Assets

Cash and Other Monetary Assets consisted of Guaranty Agency reserves (non-entity assets) as of September 30, 2005 and 2004.

| <u>(Dollars in Millions)</u> | <u>2005</u> |
|---------------------------------|-------------------------------------|
| | <u>Guaranty Agency Reserves</u> |
| Beginning Balance, September 30 | \$ 1,040 |
| Current Year Activity | (152) |
| Ending Balance, September 30 | <u>\$ 888</u> |

| <u>(Dollars in Millions)</u> | <u>2004</u> |
|---------------------------------|-------------------------------------|
| | <u>Guaranty Agency Reserves</u> |
| Beginning Balance, September 30 | \$ 1,107 |
| Current Year Activity | (67) |
| Ending Balance, September 30 | <u>\$ 1,040</u> |

Guaranty Agency reserves are held on behalf of the U.S. government, a liability due to Treasury and considered intragovernmental liabilities. These balances represent the federal government's interest in the net assets of state and nonprofit FFEL Program Guaranty Agencies. (See Note 1.)

On September 30, 2005 and 2004, Guaranty Agencies held in the Federal Fund approximately \$888 million and \$1,040 million in federal assets, respectively. The agencies use the funds to pay lender claims, primarily for loan defaults and discharges. Consistent with Section 422A(e) of the *HEA*, these funds are considered property of the United States and are reflected in the *Budget of the United States Government*.

Note 4. Credit Program Receivables and Liabilities for Loan Guarantees

The Department operates the William D. Ford Direct Student Loan Program (Direct Loan) and Federal Family Education Loan Program (FFEL) to help students finance the costs of higher education. Under the programs, the Department makes loans directly or guarantees all or a portion of loans made by participating lending institutions to individuals who meet statutorily set eligibility criteria and attend eligible institutions of higher education—public and private two- and four-year institutions, graduate schools, and vocational training schools. Students and their parents receive loans regardless of income or credit rating. Student borrowers who demonstrate financial need also receive federal interest subsidies.

Under the Direct Loan Program, the federal government makes loans directly to students and parents through participating schools. Loans are originated and serviced through contracts with private vendors. Under the FFEL Program, more than 3,200 financial institutions make loans directly to students and parents. FFEL loans are guaranteed by the federal government against default, with 35 state or private nonprofit Guaranty Agencies acting as intermediaries in administering the guarantees. Beginning with loans first disbursed on or after October 1, 1993, financial institutions became responsible for 2 percent of the cost of each default. Guaranty Agencies also began paying a portion of the cost (in most cases, 5 percent) of each defaulted loan from federal funds they hold in trust. FFEL lender participants receive statutorily set federal interest and special allowance subsidies. Guaranty Agencies receive fee payments as set by statute. In most cases, loan terms and conditions under the two programs are identical.

The *Federal Credit Reform Act of 1990 (the Act of 1990)* underlies the proprietary and budgetary accounting treatment of direct and guaranteed loans. The long-term cost to the government for direct loans or loan guarantees, other than for general administration of the programs, is referred to as “subsidy cost.” Under the Act of 1990, subsidy costs for loans obligated beginning in fiscal year 1992 are the net present value of projected lifetime costs in the year the loan is disbursed. Subsidy costs are revalued annually through the re-estimate process.

The Department estimates all future cash flows associated with Direct Loans and FFEL. Projected cash flows are used to develop subsidy estimates. Subsidy costs can be positive or negative; negative subsidies occur when expected program inflows of cash (e.g., repayments and fees) exceed expected outflows. Subsidy is recorded as the initial amount of the loan guarantee liability when guarantees are made (the loan liability) and as a valuation allowance to government-owned loans and interest receivable (i.e., direct and defaulted guaranteed loans).

The Department uses a computerized cash flow projection Student Loan Model to calculate subsidy estimates for Direct Loan and guaranteed FFEL programs. Cash flows are projected over the life of the loan, aggregated by loan type, cohort year, and risk category. The loan’s cohort year represents the year a direct loan was obligated or a loan was guaranteed, regardless of the timing of disbursements. Risk categories include two-year colleges, freshmen and sophomores at four-year colleges, juniors and seniors at four-year colleges, graduate schools, and proprietary (for-profit) schools.

Estimates reflected in these statements were prepared using assumptions developed for the FY 2006 Mid-Session Review, a governmentwide exercise required annually by the Office of Management and Budget (OMB). Assumptions regarding the volume of loan consolidations and their impact on newly repaid loans were updated after the Mid-Session Review to account for significant subsequent increases in activity. These estimates are the most

current available to the Department at the time the financial statements are prepared. Department management has a process to review these estimates in the context of subsequent changes in activity and assumptions, and to reflect the impact of these changes as appropriate.

In recent years, the consolidation of existing loans into new direct or guaranteed loans has increased significantly. Under the *Federal Credit Reform Act of 1990* and requirements provided by OMB Circular No. A-11, *Preparation, Submission, and Execution of the Budget*, the retirement of loans being consolidated is considered a receipt of principal and interest; this receipt is offset by the disbursement related to the newly created consolidation loan. The underlying direct or guaranteed loans, whether performing or nonperforming, in any given cohort are paid off in their original cohort, and new loans are opened in the cohort in which consolidation activity occurs. This consolidation activity is taken into consideration in establishing the subsidy rate for defaults.

The FFEL estimated liability for loan guarantees is reported as the present value of estimated net cash outflows. Defaulted FFEL loans are reported net of an allowance for subsidy computed using net present value methodology, including defaults, collections, and loan cancellations. The same methodology is used to estimate the allowance on Direct Loan receivables.

The Department disbursed approximately \$27.5 billion in direct loans to eligible borrowers in fiscal year 2005 and approximately \$20 billion in fiscal year 2004. Loans typically disburse in multiple installments over an academic period; as a result, loan disbursements for an origination cohort year often cross fiscal years. Half of all loan volume is obligated in the fourth quarter of the fiscal year. Regardless of the fiscal year in which they occur, disbursements are tracked by cohort as determined by the date of obligation rather than disbursement.

As of September 30, 2005 and 2004, total principal balances outstanding of guaranteed loans held by lenders were approximately \$289 billion and \$245 billion, respectively. As of September 30, 2005 and 2004, the estimated maximum government exposure on outstanding guaranteed loans held by lenders was approximately \$288 billion and \$240 billion, respectively. Of the insured amount, the Department would pay a smaller amount to the Guaranty Agencies, based on the appropriate reinsurance rates, which range from 100 to 95 percent. Any remaining insurance not paid as reinsurance would be paid to lenders by the Guaranty Agencies from their federal funds. Payments by Guaranty Agencies do not reduce government exposure because they are made from the Federal Fund administered by the agencies but owned by the federal government.

The Department accrues interest receivable and records interest revenue on its performing direct loans. Given the Department's substantial collection rates, interest receivable is also accrued and interest revenue recognized on defaulted direct loans. Guaranteed loans that default are initially turned over to Guaranty Agencies for collection, and interest receivable is accrued and recorded on the loans as the collection rate is substantial. After approximately four years, defaulted guaranteed loans not in repayment are turned over to the Department for collection; accrued interest is calculated but only realized upon collection.

As previously noted, borrowers may prepay and close out existing loans without penalty from capital raised through the disbursement of a new consolidation loan. The loan liability and net receivables include estimates of future prepayments of existing loans; they do not reflect costs associated with anticipated future consolidation loans.

Due to the nature of the loan commitment process in which schools establish a loan commitment with the filing of an aid application, which may occur before a student has been accepted by the school or begins classes, approximately 7 percent of loan commitments are never disbursed. For direct loans committed in fiscal year 2005,

an estimated \$1.6 billion will not be disbursed; for guaranteed loans committed in fiscal year 2005, an estimated \$7.1 billion will not be disbursed. Direct loan schools may originate loans through a cash advance from the Department, establishing a loan receivable, or by advancing their own funds in anticipation of reimbursement from the Department.

Loan Consolidations

Variable student loan interest rates were reset on July 1, 2005, increasing nearly two percentage points from 3.37 percent for academic year 2004-05 to 5.30 percent for academic year 2005-06. In anticipation of this increase, private lenders, schools, and others encouraged borrowers to consolidate their existing variable rate loans into fixed rate loans. This resulted in an unprecedented surge in loan consolidations, leading to substantially higher volume than the previous fiscal year.

Direct loan consolidation disbursements for fiscal year 2005 were \$15.3 billion compared to \$7.7 billion for fiscal year 2004. The effect of new consolidations is reflected in subsidy expense for the 2005 cohort, while the effect on prior cohorts of the pay-offs of underlying loans is reflected in re-estimate expense.

Based on current estimates, the prepayment of the underlying FFEL loans produces significant savings through the elimination of future special allowance payments. New consolidations are reflected in the 2005 cohort resulting in increased prepayments of underlying loans from prior cohorts. The effect of new consolidations is reflected in subsidy expense for the 2005 cohort, while the effect on prior cohorts is reflected in the re-estimate.

Credit Program Receivables, Net

The Credit Program Receivables, Net consisted of the following program loans:

| (Dollars in Millions) | 2005 | 2004 |
|---|-------------------|-------------------|
| Direct Loan Program Loan Receivables, Net | \$ 95,696 | \$ 93,747 |
| FFEL Program Loan Receivables, Net | 11,712 | 10,671 |
| Perkins Program Loan Receivables, Net | 194 | 194 |
| Credit Program Receivables, Net | \$ 107,602 | \$ 104,612 |

The following schedules summarize the Direct and defaulted FFEL Loan principal and related interest receivable, net or inclusive of the allowance for subsidy.

| Direct Loan Program Receivables | | |
|--|------------------|------------------|
| (Dollars in Millions) | 2005 | 2004 |
| Principal Receivable | \$ 94,707 | \$ 89,245 |
| Interest Receivable | 3,121 | 2,858 |
| Receivables | 97,828 | 92,103 |
| Less: Allowance for Subsidy | 2,132 | (1,644) |
| Credit Program Receivables, Net | \$ 95,696 | \$ 93,747 |

Of the \$97.8 billion in Direct Loan receivables as of September 30, 2005, \$7.2 billion in loan principal was in default and held at the Department's Borrowers Services Collections Group. As of September 30, 2004, \$6.3 billion in loan principal was in default and held at the Department's Borrowers Services Collections Group out of a total receivable of \$92.1 billion.

| FFEL Program Receivables | | | | | | |
|--|-----------------|------------------|------------------|-----------------|------------------|------------------|
| (Dollars in Millions) | 2005 | | | 2004 | | |
| | Pre-1992 | Post-1991 | Total | Pre-1992 | Post-1991 | Total |
| Principal Receivable | \$ 9,306 | \$ 8,567 | \$ 17,873 | \$ 10,324 | \$ 7,247 | \$ 17,571 |
| Interest Receivable | 595 | 1,691 | 2,286 | 857 | 1,580 | 2,437 |
| Receivables | 9,901 | 10,258 | 20,159 | 11,181 | 8,827 | 20,008 |
| Less: Allowance for Subsidy | 6,736 | 1,711 | 8,447 | 7,921 | 1,416 | 9,337 |
| Credit Program Receivables, Net | \$ 3,165 | \$ 8,547 | \$ 11,712 | \$ 3,260 | \$ 7,411 | \$ 10,671 |

Direct Loan Program Reconciliation of Allowance for Subsidy

| <u>(Dollars in Millions)</u> | <u>2005</u> | <u>2004</u> |
|--|-------------------|-------------------|
| Beginning Balance, Allowance for Subsidy | \$ (1,644) | \$ 657 |
| Components of Subsidy Transfers | | |
| Interest Rate Differential | (238) | (1,276) |
| Defaults, Net of Recoveries | 355 | 390 |
| Fees | (401) | (401) |
| Other | 1,286 | 1,117 |
| Current Year Subsidy Transfers | 1,002 | (170) |
| Components of Subsidy Re-estimates | | |
| Interest Rate Re-estimates ¹ | 1,703 | (1,526) |
| Technical and Default Re-estimates | 2,457 | 1,153 |
| Subsidy Re-estimates | 4,160 | (373) |
| Components of Teacher Loan Forgiveness Modification | | |
| Loan Modification Costs | 49 | - |
| Modification Adjustment Transfers | (1) | - |
| Teacher Loan Forgiveness Modification | 48 | - |
| Activity | | |
| Fee Collections | 461 | 450 |
| Loan Cancellations ² | (110) | (92) |
| Subsidy Allowance Amortization | (1,454) | (1,815) |
| Other | (331) | (301) |
| Total Activity | (1,434) | (1,758) |
| Ending Balance, Allowance for Subsidy | \$ 2,132 | \$ (1,644) |

¹ The interest rate re-estimate relates to subsidy associated with establishing a fixed rate for the Department's borrowing from Treasury.

² Loan cancellations include write-offs of loans because the primary borrower died, became disabled, or declared bankruptcy.

FFEL Program Reconciliation of Liabilities for Loan Guarantees

Liabilities for Loan Guarantees represent the present value of all future projected cash outflows from the Department, net of inflows such as fees, and collection of principal and interest on defaulted guaranteed loans assumed for direct collection.

The FFEL Program Liability for Loan Guarantees reconciliation is associated with the FFEL Program loans guaranteed in the financing account. The FFEL liquidating account liability for loan guarantees is included in the total Liabilities for Loan Guarantees.

| <u>(Dollars in Millions)</u> | <u>2005</u> | <u>2004</u> |
|--|------------------|------------------|
| Beginning Balance, Liability for Loan Guarantees | \$ 23,214 | \$ 15,310 |
| Components of Subsidy Transfers | | |
| Interest Supplement Costs | 12,562 | 10,087 |
| Defaults, Net of Recoveries | 865 | 888 |
| Fees | (5,554) | (4,230) |
| Other ¹ | 2,500 | 2,151 |
| Current Year Subsidy Transfers | 10,373 | 8,896 |
| Components of Subsidy Re-estimates | | |
| Interest Rate Re-estimates | (72) | 70 |
| Technical and Default Re-estimates | (586) | (1,449) |
| Subsidy Re-estimates | (658) | (1,379) |
| Components of Teacher Loan Forgiveness Modification | | |
| Loan Modification Costs | 148 | - |
| Modification Adjustment Transfers | (3) | - |
| Teacher Loan Forgiveness Modification | 145 | - |
| Activity | | |
| Interest Supplement Payments | (5,077) | (2,345) |
| Claim Payments | (3,716) | (2,803) |
| Fee Collections | 3,060 | 2,588 |
| Interest on Liability Balance | 565 | 436 |
| Other ² | 2,594 | 2,511 |
| Total Activity | (2,574) | 387 |
| Ending Balance, Liability for Loan Guarantees | 30,500 | 23,214 |
| FFEL Liquidating Account Liability for Loan Guarantees | 111 | 115 |
| Total Liabilities for Loan Guarantees | \$ 30,611 | \$ 23,329 |

¹ Subsidy primarily associated with debt collections and loan cancellations due to death, disability, and bankruptcy.

² Activity primarily associated with the transfer of subsidy for defaults; loan consolidation activity; and loan cancellations due to death, disability, and bankruptcy.

Teacher Loan Forgiveness Modification of Subsidy Cost

The *Taxpayer-Teacher Protection Act of 2004* (P.L. 108-409) increased the maximum amount of loan cancellation from \$5,000 to \$17,500 at the end of the fifth year of teaching for certain teachers who were new student loan borrowers between October 1, 1998 and October 1, 2005, as described in Dear Colleague letter GEN-04-14. According to OMB Circular No. A-11, Section 185.3, any government action that differs from actions assumed in the baseline estimate of cash flows and changes the estimated cost of an outstanding direct loan or any outstanding loan guarantee is defined as a modification. The FFEL Program recognized \$148 million and the Direct Loan Program recognized \$49 million in modification costs in fiscal year 2005.

Separate amounts are calculated for modification costs and modification adjustment transfers. Modification adjustment transfers are required to adjust for the difference between cohort discount rates used to calculate modification costs and the discount rates used to calculate cohort interest expense and revenue. The FFEL Program recognized a net modification adjustment transfer gain of \$3 million, while the Direct Loan Program recognized a net gain of \$1 million.

Direct Loan Financing Account Interest Expense and Revenue

The Direct Loan Financing Account borrows from Treasury to fund the unsubsidized portion of its lending activities and, as required, calculates and pays Treasury interest at the end of each year. Interest is earned on the outstanding Direct Loan portfolio during the year. The Financing Account is paid interest by Treasury on its weighted average fund balance with Treasury at year-end. Subsidy amortization is calculated, as required in Statement of Federal Financial Accounting Standards No. 2 (SFFAS No. 2), *Accounting for Direct Loans and Loan Guarantees*, as the difference between interest revenue and interest expense. The allowance for subsidy is adjusted with the offset to interest revenue.

| Direct Loan Financing Account Interest Expense and Revenue | | |
|---|-----------------|-----------------|
| (Dollars in Millions) | 2005 | 2004 |
| Interest Expense on Treasury Borrowing | \$ 6,171 | \$ 5,761 |
| Interest Expense | \$ 6,171 | \$ 5,761 |
| Interest Revenue from the Public | \$ 3,242 | \$ 2,946 |
| Amortization of Subsidy | 1,454 | 1,815 |
| Interest Revenue on Uninvested Funds | 1,475 | 1,000 |
| Interest Revenue | \$ 6,171 | \$ 5,761 |

Subsidy Expense

| Direct Loan Program Subsidy Expense | | |
|---|-----------------|-----------------|
| (Dollars in Millions) | 2005 | 2004 |
| Components of Current Year Subsidy Transfers | | |
| Interest Rate Differential | \$ (238) | \$ (1,276) |
| Defaults, Net of Recoveries | 355 | 390 |
| Fees | (401) | (401) |
| Other | 1,286 | 1,117 |
| Current Year Subsidy Transfers | 1,002 | (170) |
| Subsidy Re-estimates | 4,160 | (373) |
| Loan Modification Costs | 49 | - |
| Direct Loan Subsidy Expense | \$ 5,211 | \$ (543) |

In the 2005 re-estimates, Direct Loan subsidy expense was increased by \$4.2 billion. Changes in assumptions for variables (such as assumed term and maturity, loan volume and prepayment rates) increased subsidy expense by \$4.0 billion. The remaining \$195 million increase is related to changes in actual and forecasted interest rates. A 1 percent increase in projected borrower base rates would reduce projected Direct Loan costs by \$1.1 billion. In the 2004 re-estimates, Direct Loan subsidy expense was reduced by \$373 million. Changes in actual and forecasted interest rates reduced subsidy expense by \$847 million. The re-estimate related to changes in assumptions for other variables increased subsidy expense by \$474 million.

| FFEL Program Loan Guarantee Subsidy Expense | | |
|---|-----------------|-----------------|
| (Dollars in Millions) | 2005 | 2004 |
| Components of Current Year Subsidy Transfers | | |
| Interest Supplement Costs | \$ 12,562 | \$ 10,087 |
| Defaults, Net of Recoveries | 865 | 888 |
| Fees | (5,554) | (4,230) |
| Other | 2,500 | 2,151 |
| Current Year Subsidy Transfers | 10,373 | 8,896 |
| Subsidy Re-estimates | (658) | (380) |
| Loan Modification Costs | 148 | - |
| FFEL Loan Guarantee Subsidy Expense | \$ 9,863 | \$ 8,516 |

In the 2005 re-estimates, FFEL subsidy expense was decreased by \$658 million. An increase of \$932 million was caused by changes in actual and forecasted interest rates. Changes in assumptions for variables (such as assumed term and maturity, loan volume and prepayment rates) decreased subsidy expense by \$1.6 billion. A 1 percent increase in borrower interest rates and the guaranteed yield for lenders would increase projected FFEL costs by \$6.4 billion. In the 2004 re-estimates, FFEL subsidy expense was reduced by \$380 million, of which changes in actual and forecasted interest rates reduced subsidy expense by \$352 million. The re-estimate related to changes in assumptions for other variables reduced subsidy expense by \$28 million.

Subsidy Rates

The subsidy rates applicable to the 2005 loan cohort year were as follows:

| Subsidy Rates – Cohort 2005 | | | | | |
|------------------------------------|----------------------------------|-----------------|-------------|--------------|--------------|
| | Interest Differential | Defaults | Fees | Other | Total |
| Direct Loan Program | (.60%) | 1.16% | (1.33%) | 4.24% | 3.47% |
| | Interest Supplements | Defaults | Fees | Other | Total |
| FFEL Program | 13.66% | .93% | (6.01%) | 2.67% | 11.25% |

These subsidy rates cannot be applied to direct or guaranteed loans disbursed during the current reporting year to yield the subsidy expense, nor are these rates applicable to the portfolio as a whole. The subsidy expense for new direct or guaranteed loans reported in the current year relate to disbursements of loans from both current and prior years' cohorts. Subsidy expense is recognized when direct loans are disbursed by the Department or third-party lenders disburse guaranteed loans.

The costs of the Department's student loan programs, especially the Direct Loan Program, are highly sensitive to changes in actual and forecasted interest rates. The formulas for determining program interest rates are established by statute; the existing loan portfolio has a mixture of borrower and lender rate formulas. Governmentwide interest rate projections are developed by the President's Office of Management and Budget.

Administrative Expenses

The administrative expenses for Direct Loan and FFEL programs were as follows:

| | 2005 | | 2004 | |
|--------------------------------------|---------------------------|----------------------|---------------------------|----------------------|
| (Dollars in Millions) | <u>Direct Loan</u> | <u>FFEL</u> | <u>Direct Loan</u> | <u>FFEL</u> |
| Operating Expense | \$ 401 | \$ 268 | \$ 409 | \$ 281 |
| Other Expense | 17 | 8 | 10 | - |
| Total Administrative Expenses | <u>\$ 418</u> | <u>\$ 276</u> | <u>\$ 419</u> | <u>\$ 281</u> |

Perkins Loan Program

The Perkins Loan Program is a campus-based program providing financial assistance to eligible postsecondary school students. In fiscal year 2004, new federal capital contributions of \$99 million were provided to make loans to eligible students through participating schools at 5 percent interest. No new federal capital contributions were appropriated in fiscal year 2005. In some statutorily defined cases, funds are provided to schools so that student loans may be cancelled. For certain defaulted loans, the Department reimburses the originating school and collects from the borrowers. These collections are transferred to the Treasury. At September 30, 2005 and 2004, loans receivable, net of an allowance for loss, were \$194 million. These loans are valued at historical cost.

Note 5. Accounts Receivable

Accounts receivable consisted of the following at September 30, 2005 and 2004:

| <u>(Dollars in Millions)</u> | 2005 | | |
|----------------------------------|------------------------------|------------------|----------------------------|
| | <u>Gross Receivables</u> | <u>Allowance</u> | <u>Net Receivables</u> |
| Intragovernmental | \$ - | \$ - | \$ - |
| With the Public | 153 | (22) | 131 |
| Total Accounts Receivable | \$ 153 | \$ (22) | \$ 131 |

| <u>(Dollars in Millions)</u> | 2004 | | |
|----------------------------------|------------------------------|------------------|----------------------------|
| | <u>Gross Receivables</u> | <u>Allowance</u> | <u>Net Receivables</u> |
| Intragovernmental | \$ - | \$ - | \$ - |
| With the Public | 178 | (37) | 141 |
| Total Accounts Receivable | \$ 178 | \$ (37) | \$ 141 |

Accounts receivable represent balances due from recipients of grant and other financial assistance programs, and reimbursable agreements from other federal agencies. They are recorded at their estimated net realizable value. Estimates for the allowance for loss on uncollectible accounts are based on historical data.

Note 6. Treasury Debt

FSA's Debt to the Treasury consisted of the following as of September 30, 2005 and 2004:

| (Dollars in Millions) | 2005 | 2004 |
|------------------------------|-------------------|------------------|
| Beginning Balance | \$ 96,421 | \$ 91,787 |
| Accrued Interest | (2) | 1 |
| New Borrowing | 31,299 | 21,191 |
| Repayments | (23,346) | (16,558) |
| Ending Balance | \$ 104,372 | \$ 96,421 |

Funds were borrowed to provide funding for direct loans to students.

The level of repayments on borrowings to Treasury is derived from many factors:

- Beginning-of-the-year cash balance, collections, interest collections, disbursements, and interest payments have an impact on the available cash to repay Treasury.
- Cash is held to cover future liabilities, such as contract collection costs and disbursements in transit.

Note 7. Payable to Treasury

At September 30, 2005 and 2004, Payable to the Treasury for estimated liquidating fund future cash inflows in excess of outflows and for downward re-estimates of subsidy is shown in the table below:

| (Dollars in Millions) | 2005 | 2004 |
|---|-----------------|-----------------|
| Future Liquidating Account Collections, Beginning Balance | \$ 3,491 | \$ 3,761 |
| Valuation of Pre-1992 Loan Liability and Allowance | 851 | 847 |
| Capital Transfers to Treasury | (931) | (1,117) |
| Future Liquidating Account Collections, Ending Balance | 3,411 | 3,491 |
| FFEL Downward Subsidy Re-estimate | 1,755 | 1,502 |
| Total Payable to Treasury | \$ 5,166 | \$ 4,993 |

In accordance with the *Federal Credit Reform Act of 1990*, the liquidating fund pays monies to Treasury each year based on available fund balances, and the FFEL financing fund pays the liability related to downward subsidy re-estimates upon budget execution.

Note 8. Other Liabilities

Other liabilities include current liabilities for contractual services, administrative services, deferred credits, liability for deposit funds, contingent liabilities, custodial liabilities, and the liability for unfunded accrued annual leave. Additionally, the noncurrent liabilities include accrued unfunded FECA. Other liabilities consisted of the following at September 30, 2005 and 2004:

| <u>(Dollars in Millions)</u> | <u>2005</u> | <u>2004</u> |
|---------------------------------|---------------|---------------|
| Intragovernmental | | |
| Accrued Unfunded FECA Liability | \$ 1 | \$ 1 |
| Advances to Others | 1 | - |
| Total Intragovernmental | 2 | 1 |
| With the Public | | |
| Accrued Payroll and Benefits | 4 | 4 |
| Accrued Unfunded Annual Leave | 7 | 7 |
| Custodial Liability | 194 | 194 |
| Deferred Credits | 1 | 1 |
| Liability for Deposit Funds | 8 | 8 |
| Other Liabilities | 13 | 59 |
| Total With the Public | 227 | 273 |
| Total Other Liabilities | \$ 229 | \$ 274 |

Note 9. Liabilities Not Covered by Budgetary Resources

Liabilities on FSA's Balance Sheet as of September 30, 2005 and 2004, include liabilities for which congressional action is needed before budgetary resources can be provided. Although future appropriations to fund these liabilities are likely, it is not certain that appropriations will be enacted to fund these liabilities. Liabilities not covered by budgetary resources consisted of the following:

| <u>(Dollars in Millions)</u> | <u>2005</u> | <u>2004</u> |
|---|-------------------|-------------------|
| Intragovernmental | | |
| Accrued Unfunded FECA Liability | \$ 1 | \$ 1 |
| Total Intragovernmental | 1 | 1 |
| With the Public | | |
| Custodial Liability | 194 | 194 |
| Accrued Unfunded Annual Leave | 7 | 7 |
| Federal Employee and Veterans' Benefits | 4 | 4 |
| Total With the Public | 205 | 205 |
| Liabilities Not Covered by Budgetary Resources | 206 | 206 |
| Liabilities Covered by Budgetary Resources | 142,249 | 126,863 |
| Total Liabilities | \$ 142,455 | \$ 127,069 |

Note 10. Accrued Grant Liability

FSA's accrued grant liability was \$635 million as of September 30, 2005 and \$637 million as of September 30, 2004. (See Note 1.)

Note 11. Net Position

The nature of FSA's net position was discussed in Note 1, and the components are set forth in the Statement of Changes in Net Position. The table below reports the composition of appropriations that have not been used to fund goods and services received or benefits provided as of September 30, 2005 and 2004:

| <u>(Dollars in Millions)</u> | <u>2005</u> | <u>2004</u> |
|--|------------------------|------------------------|
| Unobligated Balances | | |
| Available | \$ 31 | \$ 26 |
| Not Available | 170 | 198 |
| Undelivered Orders | <u>8,396</u> | <u>8,957</u> |
| Total Unexpended Appropriations | <u>\$ 8,597</u> | <u>\$ 9,181</u> |

Undelivered orders and unobligated balances for federal credit financing and liquidating funds are not included in the chart above because they are not funded through appropriations. As a result, unobligated and undelivered order balances in the chart above will differ from these balances in the Combined Statement of Budgetary Resources.

FSA had Cumulative Results of Operations of (\$4,547) million as of September 30, 2005, and (\$3,062) million as of September 30, 2004. Cumulative Results of Operations consist mostly of purchases of capitalized assets and unfunded expenses, including upward subsidy re-estimates for loan programs.

Note 12. Interest Revenue and Expense

For the Direct Loan Program, interest revenue is earned on the individual loans in the loan portfolio, while federal interest is earned on the uninvested fund balances with Treasury. For the Direct Loan Program, interest expense is recognized on the Department's borrowings from Treasury. For the FFEL Program, federal interest revenue is earned on the uninvested fund balance with Treasury in the financing fund.

The interest revenues and expenses attributable to the Direct Loan Program and the FFEL Program are summarized below:

| | Direct Loan Program | | FFEL Program | | Total | |
|-------------------------------|---------------------|-----------------|---------------|---------------|-----------------|-----------------|
| (Dollars in Millions) | 2005 | 2004 | 2005 | 2004 | 2005 | 2004 |
| Interest Revenue: | | | | | | |
| Federal | \$ 1,475 | \$ 1,000 | \$ 565 | \$ 436 | \$ 2,040 | \$ 1,436 |
| Non-federal | 4,696 | 4,761 | - | - | 4,696 | 4,761 |
| Total Interest Revenue | \$ 6,171 | \$ 5,761 | \$ 565 | \$ 436 | \$ 6,736 | \$ 6,197 |
| Interest Expense: | | | | | | |
| Federal | \$ 6,171 | \$ 5,761 | \$ 565 | \$ 436 | \$ 6,736 | \$ 6,197 |
| Non-federal | - | - | - | - | - | - |
| Total Interest Expense | \$ 6,171 | \$ 5,761 | \$ 565 | \$ 436 | \$ 6,736 | \$ 6,197 |

Note 13. Statement of Budgetary Resources

The Statement of Budgetary Resources compares budgetary resources with the status of those resources. As of September 30, 2005, budgetary resources were \$108,106 million and net outlays were \$25,842 million. As of September 30, 2004, budgetary resources were \$84,202 million and net outlays were \$21,635 million.

Apportionment Categories of Obligations Incurred

FSA receives apportionments of its resources from the Office of Management and Budget (OMB). Category A apportionments are those resources that can be obligated without restriction on the purpose of the obligation, other than to be in compliance with legislation underlying programs for which the resources were made available. Category B apportionments are restricted by purpose for which obligations can be incurred. In addition, some resources are available without apportionment by OMB.

The apportionment categories of obligations incurred as of September 30, 2005 and 2004, are summarized below:

| (Dollars in Millions) | 2005 | 2004 |
|---|------------------|------------------|
| Direct and Reimbursable: | | |
| Category A | \$ 736 | \$ 719 |
| Category B | 82,872 | 66,736 |
| Exempt from Apportionment | 252 | 52 |
| Total Apportionment Categories of Obligations Incurred | \$ 83,860 | \$ 67,507 |

Permanent Indefinite Budget Authority

The Federal Direct Loan Program and the Federal Family Education Loan Program were granted permanent indefinite budget authority through legislation. Part D of the William D. Ford Federal Direct Loan Program and Part B of the Federal Family Education Loan Program, pursuant to the *HEA*, pertains to the existence, purpose, and availability of this permanent indefinite budget authority.

Reauthorization of Legislation

Funds for most Department of Education programs are authorized, by statute, to be appropriated for a specified number of years, with an automatic one-year extension available under Section 422 of the *General Education Provisions Act*. Congress may continue to appropriate funds after the expiration of the statutory authorization period, effectively reauthorizing the program through the appropriations process. The current *Budget of the United States Government* presumes all programs continue per congressional budgeting rules.

Unused Borrowing Authority

FSA is given authority to draw funds from the Treasury to help finance the majority of its direct lending activity. Unliquidated Borrowing Authority is a budgetary resource and is available to support obligations. FSA periodically reviews its borrowing authority balances in relation to its obligations and may cancel unused amounts. Unused Borrowing Authority as of September 30, 2005 and 2004, was determined as follows:

| (Dollars in Millions) | 2005 | 2004 |
|---|-----------------|-----------------|
| Beginning Balance, Unused Borrowing Authority | \$ 5,897 | \$ 6,970 |
| Current Year Borrowing Authority | 32,170 | 22,383 |
| Funds Drawn From Treasury | (31,299) | (21,191) |
| Prior Year Unused Borrowing Authority Cancelled | (1,326) | (2,265) |
| Ending Balance, Unused Borrowing Authority | \$ 5,442 | \$ 5,897 |

Comparison to the Budget of the United States Government

Statement of Federal Financial Accounting Standards No. 7 (SFFAS No. 7), *Accounting for Revenue and Other Financing Sources and Concepts for Reconciling Budgetary and Financial Accounting*, requires an explanation of material differences between budgetary resources available, the status of those resources, and outlays as presented in the Statement of Budgetary Resources to the related actual balances published in the *Budget of the United States Government (President's Budget)*. However, the *President's Budget* has not yet been published. The *President's Budget* is scheduled for publication in February 2006 and will be available through OMB. Accordingly, information required for such disclosure is not available at the time of publication of these financial statements. There were no material differences between the Fiscal Year 2004 column on the Statement of Budgetary Resources and the fiscal year 2004 actual amounts reported in the *President's Budget*.

Note 14. Statement of Financing

The Statement of Financing (SOF) provides information on the total resources used by an agency, both those received through budgetary resources and those received through other means during the reporting period. The statement reconciles these resources with the net cost of operations by (1) removing resources that do not fund net cost of operations and (2) including components of net cost of operations that did not generate or use resources during the year.

The SOF is presented as a consolidated statement for FSA and its major programs. Net interagency eliminations are presented for proprietary amounts. The budgetary amounts are reported on a combined basis as presented in the Statement of Budgetary Resources. Accordingly, net interagency eliminations for budget amounts are not presented.

The difference between the amounts reported as liabilities not covered by budgetary resources on the Balance Sheet and amounts reported as other components requiring or generating resources in future periods on the Statement of Financing represents a decrease in custodial liability activities.

Components Not Requiring or Generating Resources primarily result from the subsidy expense recognized for financial statement re-estimate purposes as required by the Statement of Federal Financial Accounting Standards No. 2 (SFFAS No. 2), *Accounting for Direct Loans and Loan Guarantees*. Re-estimates published in the *President's Budget* generate or require resources.

Note 15. Contingencies

Guaranty Agencies

The Department can assist Guaranty Agencies experiencing financial difficulties by advancing funds or by other means. No provision has been made in the principal statements for potential liabilities related to financial difficulties of Guaranty Agencies because the likelihood of such occurrences is uncertain and cannot be estimated with sufficient reliability.

Perkins Loan Reserve Funds

The Perkins Loan Program is a campus-based program providing financial assistance to eligible postsecondary school students. In fiscal year 2005, the Department provided funding of 84.6 percent of the capital used to make loans to eligible students through participating schools at 5 percent interest. The schools provided the remaining 15.4 percent of program funding. For the latest academic year ended June 30, 2005, approximately 779,129 loans were made, totaling approximately \$1.6 billion at 1,653 institutions, averaging \$2,069 per loan. The Department's share of the Perkins Loan Program was approximately \$6.4 billion as of June 30, 2005.

In fiscal year 2004, the Department provided funding of 84.8 percent of the capital used to make loans to eligible students through participating schools at 5 percent interest. The schools provided the remaining 15.2 percent of program funding. For the academic year ended June 30, 2004, approximately 750,420 loans were made, totaling \$1.6 billion at 1,700 institutions, averaging \$2,161 per loan. The Department's share of the Perkins Loan Program was approximately \$6.5 billion as of June 30, 2004.

Perkins Loan borrowers who meet statutory eligibility requirements—such as service as a teacher in low-income areas, as a Peace Corps or VISTA volunteer, in the military or in law enforcement, in nursing, or in family services—may receive partial loan forgiveness for each year of qualifying service. In these circumstances, a contingency is deemed to exist. The Department may be required to compensate Perkins Loan institutions for the cost of the partial loan forgiveness.

Litigation and Other Claims

The Department is involved in various lawsuits incidental to its operations. Judgments resulting from litigation against the Department are paid by the Department of Justice. In the opinion of management, the ultimate resolution of pending litigation will not have a material effect on the Department's financial position.

Hurricanes Katrina and Rita

On August 29, 2005, Hurricane Katrina struck the Gulf Coast, resulting in widespread catastrophic damage to the coastal regions of Louisiana, Mississippi and Alabama. Hurricane Katrina is expected to be the costliest natural disaster in U.S. history. Immediately following Katrina, Hurricane Rita struck the Gulf Coast, adding Texas to the states already catastrophically damaged and hindering recovery efforts. The death toll, property damage, dislocation of families, and destruction of the infrastructure of the communities and economies of the Gulf Coast represent a humanitarian crisis that will affect these areas for many years to come.

To begin the reconstruction of the education process, the Department of Education has been asked by the White House to render all appropriate assistance to the region's loan applicants, students, borrowers, guaranty agencies, educational institutions and other program participants. It is impossible at this time to accurately estimate the impact of Hurricanes Katrina and Rita on the education systems, educational facilities, teachers, students, and financial institutions of the affected areas, or the demands or costs that this impact will place on the Department of Education. Any potential financial impact will relate to a future period rather than a current period.

Other Matters

Some portion of the current year financial assistance expenses (grants) may include funded recipient expenditures that were subsequently disallowed through program review or audit processes. In the opinion of management, the ultimate disposition of these matters will not have a material effect on the Department's financial position.

Section III
Required
Supplementary
Stewardship
Information

Required Supplementary Stewardship Information

This section provides information on certain resources entrusted to Federal Student Aid and certain responsibilities assumed by it that cannot be measured in traditional financial statement reports. These resources and responsibilities do not meet the criteria for assets and liabilities that are required to be reported in the financial statements, but they are important to understanding the operations and financial condition of Federal Student Aid.

Stewardship Property, Plant and Equipment

Heritage Assets and Stewardship Land

Heritage assets are unique for their historical or natural significance, for their cultural, educational, or artistic importance, or for their significant architectural characteristics. Stewardship land is land (and land rights) not acquired for or in connection with items of general PP&E. Federal Student Aid has no assets that meet the criteria for either a heritage asset or stewardship land.

Stewardship Investments

Stewardship investments are substantial investments made by the U.S. Government for the benefit of the U.S., but are not physical assets owned by the U.S. Government.

Non-Federal Physical Property

Federal Student Aid has no assets that meet the criteria for non-federal physical property.

Human Capital

Federal investment in Human Capital comprises those expenses for general public education and training programs that are intended to increase or maintain national economic productive capacity. The Department of Education's Human Capital programs are administered by the following offices: Elementary and Secondary Education, Safe and Drug-Free Schools, Innovation and Improvement, Postsecondary Education, Federal Student Aid, Special Education and Rehabilitative Services, Institute of Education Sciences, English Language Acquisition, and Vocational and Adult Education.

The Office of Federal Student Aid administers need-based financial assistance programs for students pursuing postsecondary education. The Department makes available federal grants, loans, and work-study funding to eligible undergraduate and graduate students. The Department's major programs are:

The Federal Family Education Loan Program operates with state and private nonprofit Guaranty Agencies to provide loan guarantees and interest

Required Supplementary Stewardship Information

supplements through permanent budget authority on loans by private lenders to eligible students.

The William D. Ford Direct Student Loan Program is a direct lending program in which loan capital is provided to students by the federal government through borrowings from the U.S. Treasury.

The Federal Pell Grant Program awards direct grants through participating institutions to undergraduate students with financial need. Participating institutions either credit the appropriated funds to the student's school account, or pay the student directly once per term.

Campus Based Programs include the Supplemental Educational Opportunity Grant, Work-Study, and Perkins Loan programs. Grants in these programs are made directly to participating institutions, which have considerable flexibility to package awards to best meet the needs of their students.

Research and Development

Research and development investments are expenses included in the calculation of net costs to support the search for new or refined knowledge and ideas for the application of use of such knowledge and ideas for the development of new or improved products and processes, with the expectation of yielding a future benefit. While Federal Student Aid is progressive in its research and development of methods to further its mission, it has no substantial research and development expenses.

Summary of Minimum Reporting Requirements

Program Outputs

The table below highlights Federal Student Aid's fiscal year 2005 expenses for public education and training programs intended to enhance the quality of education provided to students.

| Summary of Human Capital Expenses | | | | | |
|------------------------------------|---------------|---------------|---------------|---------------|---------------|
| (Dollars in Millions) | 2005 | 2004 | 2003 | 2002 | 2001 |
| Federal Student Aid Expense | | | | | |
| Direct Loan Subsidy | \$ 5,211 | \$ (543) | \$ 4,716 | \$ 877 | \$ 1,307 |
| Guaranteed Loan Subsidy | 9,863 | 8,516 | 2,509 | 3,988 | (314) |
| Grant Programs | 15,070 | 14,943 | 13,836 | 12,256 | 10,812 |
| Salaries & Administrative | 164 | 186 | 179 | 207 | 249 |
| Total | 30,308 | 23,102 | 21,240 | 17,328 | 12,054 |

Program Outcomes

Federal Student Aid's programs link with the overall initiatives of the Department in enhancing education—a fundamental stepping-stone to higher living standards for American citizens. Education is key to national economic growth. But education's contribution is more than increased productivity and incomes. Education improves health, promotes social change, and opens doors to a better future for children and adults.

Economic outcomes, such as wage and salary levels, historically have been determined by the educational attainment of individuals and the skills employers expect of those entering the labor force. Recently, both individuals and society as a whole have placed increased emphasis on educational attainment as the workplace has become increasingly technological and employers now seek employees with the highest level of skills. For prospective employees, the focus on higher-level skills means investing in learning or developing skills through education. Like all investments, developing higher-level skills involves costs and benefits.

Returns, or benefits, of investing in education come in many forms. While some returns accrue for the individual, others benefit society and the nation in general. Returns related to the individual include higher earnings, better job opportunities, and jobs that are less sensitive to general economic conditions. Returns related to the economy and society include reduced reliance on welfare subsidies, increased participation in civic activities, and greater productivity.

Over time, the returns of developing skills through education have become evident. Statistics illustrate the rewards of completing high school and investing in postsecondary education.

Unemployment rate. Persons with lower levels of educational attainment were more likely to be unemployed than those who had higher levels of educational attainment. The 2005 unemployment rate for adults (25 years old and over) who had not completed high school was 8.2 percent compared with 5.0 percent of those with four years of high school and 2.4 percent for those with a bachelor's degree or higher. Younger people with high school diplomas tended to have higher unemployment rates than persons 25 and over with similar levels of education.

Annual income. As of September 2005, the annualized median income for adults (25 years and over) varied considerably by education level. Men with a high school diploma earned \$33,800, compared with \$60,736 for men with a college degree. Women with a high school diploma earned \$25,532, compared with \$45,448 for women with a college degree. Men and women with college degrees earned 77.3 percent more than men and women with high school

Required Supplementary Stewardship Information

diplomas. Earnings for workers with college degrees have increased in the past year by 2.8 percent for women and 4.0 percent for men. These returns of investing in education directly translate into the advancement of the American economy as a whole.

Stewardship Responsibilities

Social Insurance

Federal Student Aid has no social insurance programs.

Section IV
Office of Inspector
General Transmittal
Letter to Secretary of
Education



UNITED STATES DEPARTMENT OF EDUCATION

OFFICE OF INSPECTOR GENERAL

THE INSPECTOR GENERAL

NOV 18 2005

Theresa S. Shaw
Chief Operating Officer
Federal Student Aid
Washington, D.C. 20202

Dear Ms. Shaw:

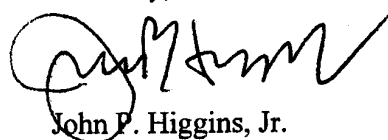
The enclosed reports present the results of the annual audits of Federal Student Aid's (FSA) financial statements for fiscal years 2005 and 2004, to comply with the Higher Education Act Amendments of 1998. The reports should be read in conjunction with FSA's financial statements and notes to fully understand the context of the information contained therein.

We contracted with the independent certified public accounting firm of Ernst & Young, LLP (Ernst & Young) to audit the financial statements of FSA as of September 30, 2005 and 2004, and for the years then ended. The contract required that the audit be performed in accordance with U.S. generally accepted government auditing standards; OMB's bulletin, *Audit Requirements for Federal Financial Statements*; and the GAO/PCIE *Financial Audit Manual*.

In connection with the contract, we monitored the performance of the audits, reviewed Ernst & Young's reports and related documentation, and inquired of its representatives. Our review was not intended to enable us to express, and we do not express, an opinion on FSA's financial statements, or conclusions about the effectiveness of internal control, whether FSA's financial management systems substantially complied with the Federal Financial Management Improvement Act of 1996, or on compliance with laws and regulations.

Ernst & Young is responsible for the attached auditor's report and the conclusions expressed in the related reports on internal control and compliance with laws and regulations. Our review disclosed no instances where Ernst & Young did not comply, in all material respects, with U.S. generally accepted government auditing standards.

Sincerely,



John P. Higgins, Jr.

Enclosures

Section V
Report of Independent
Auditors

Report of Independent Auditors

To the Inspector General
U.S. Department of Education

We have audited the accompanying consolidated balance sheets of Federal Student Aid (FSA), a performance-based organization of the U.S. Department of Education (the Department) as of September 30, 2005 and 2004, and the related consolidated statements of net cost, changes in net position, and financing and the combined statements of budgetary resources for the fiscal years then ended. These financial statements are the responsibility of FSA's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and Office of Management and Budget (OMB) Bulletin No. 01-02, *Audit Requirements for Federal Financial Statements*. Those standards and bulletin require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. We were not engaged to perform an audit of FSA's internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of FSA's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

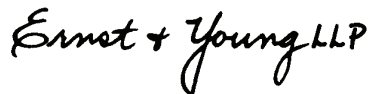
In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of FSA as of September 30, 2005 and 2004, and its net costs, changes in net position, budgetary resources, and reconciliation of net costs to budgetary obligations for the years then ended, in conformity with accounting principles generally accepted in the United States.

Our audits were conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The information presented in the Management Discussion and Analysis and required supplementary stewardship information is not a required part of the basic financial statements but is supplementary information required by OMB Circular No. A-136, *Financial Reporting Requirements*. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit the information and express no opinion on it.

Report of Independent Auditors

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In accordance with *Government Auditing Standards*, we have also issued our reports dated November 2, 2005, on our consideration of FSA's internal control over financial reporting and on our tests of its compliance with certain provisions of laws and regulations and other matters. The purpose of those reports is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. Those reports are an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audits.



November 2, 2005

Section VI

Report on Internal Control

Report on Internal Control

To the Inspector General
U.S. Department of Education

We have audited the consolidated balance sheet of Federal Student Aid (FSA), a performance-based organization of the U.S. Department of Education (the Department) as of September 30, 2005, and the related consolidated statements of net cost, changes in net position, and financing and the combined statement of budgetary resources for the fiscal year then ended, and have issued our report thereon dated November 2, 2005. We conducted our audit in accordance with auditing standards generally accepted in the United States; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and Office of Management and Budget (OMB) Bulletin No. 01-02, *Audit Requirements for Federal Financial Statements*.

In planning and performing our audit, we considered FSA's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide an opinion on internal control over financial reporting. We limited our internal control testing to those controls necessary to achieve the objectives described in OMB Bulletin No. 01-02. We did not test all internal controls relevant to operating objectives as broadly defined by the Federal Managers' Financial Integrity Act of 1982 (FMFIA), such as those controls relevant to ensuring efficient operations.

In addition, we considered the Department's internal control over Required Supplementary Stewardship Information by obtaining an understanding of the agency's internal control, determined whether internal control had been placed in operation, assessed control risk, and performed tests of controls as required by OMB Bulletin No. 01-02 and not to provide assurance on internal control. Accordingly, we do not provide an opinion on such controls.

With respect to internal controls related to performance measures reported in the Management Discussion and Analysis of FSA's consolidated and combined financial statements, we obtained an understanding of the design of significant internal control relating to the existence and completeness assertions, as required by OMB Bulletin No. 01-02. Our procedures were not designed to provide assurance on internal control over reported performance measures, and, accordingly, we do not provide an opinion on such controls.

However, as a result of the procedures we did perform, we noted certain matters involving the internal control over financial reporting and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect FSA's ability to initiate, record, process, and report financial data consistent with the assertions of management in the financial statements. The reportable conditions are described below.

Report on Internal Control

Page 2

A material weakness is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by errors or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, we believe none of the reportable conditions described below is a material weakness.

FSA relies on the Department's Office of Chief Financial Officer (OCFO) to provide support for FSA's financial reporting needs. Specifically, FSA has a memorandum of understanding (MOU) with OCFO that indicates that OCFO is responsible for the following: (1) preparing FSA's financial statements; (2) performing the daily operations of processing transactions in the general ledger; (3) preparing the required financial reporting to the Office of Management and Budget and the U.S. Department of the Treasury, such as the SF-133 and the SF-224; and (4) developing and distributing accounting policies and procedures.

In addition, under the MOU, FSA is responsible for: (1) implementing accounting policies and procedures; (2) coordinating with OCFO and Budget Service on all financial reporting issues; and (3) reconciling subsidiary ledgers to supporting documentation and ledgers.

REPORTABLE CONDITIONS**1. Continued Focus on Credit Reform Estimation and Financial Reporting Processes is Warranted (Modified Repeat Condition)**

The Federal Credit Reform Act of 1990, as amended, was enacted to require agencies to more accurately measure and budget for the cost of federal loan programs. In implementing the requirements of the Credit Reform Act, and in complying with Federal accounting standards, agencies are required to estimate the net cost of extending credit over the life of a direct loan or guaranteed loan based on the present value of estimated net cash flows, excluding certain administrative costs. Such costs are also re-estimated on a periodic basis. While improvements were made over the last several years, we noted that the management controls surrounding the calculation and reporting of the loan liability activity and subsidy estimates should be further refined and implemented earlier in the process to ensure that appropriate estimates are prepared. OMB Circular A-123, *Management Accountability and Control*, defines management controls as "the organization, policies, and procedures used to reasonably ensure that (i) programs achieve their intended results; (ii) resources are used consistent with agency mission; (iii) programs and resources are protected from waste, fraud, and mismanagement; (iv) laws and regulations are followed; and (v) reliable and timely information is obtained, maintained, reported and used for decision making."

Report on Internal Control

Page 3

During fiscal year (FY) 2005, we noted that the Department and FSA continued to make progress on this reportable condition. The Credit Reform Workgroup (CRW), which was created in FY 2004 and consists of managers from OCFO, FSA, and Budget Service, met twice in FY 2005. The primary purpose of the CRW was to inform the appropriate parties of key internal issues related to credit reform, and to manage the development of improved processes, procedures and sources of information to enhance the credit reform estimation process.

The CRW has made progress in many areas, although the work is still ongoing. A primary focus for the upcoming fiscal year is on monitoring activities for credit reform estimates. In addition, assumption and business process subgroups will focus on efforts to ensure accurate cohort accounting within the Department's systems. The end objective continues to be a well-defined process, which includes appropriate and robust checks and edits, as well as documentation of key decisions and rationales.

However, after identifying the key improvements made or currently being made by the Department and FSA, during our testing of loan guarantees, allowance for subsidy, and subsidy cost estimates, we noted the following items that indicate management controls and analysis should be strengthened:

- The long-term cost for the credit programs is reflected in the financial statements through periodic charges for subsidy costs, adjustments or re-estimates to those subsidy costs, and loan activity, which is all recognized in the allowance for the direct loan (DL) receivable and liability for the guaranteed loan (FFEL) program. The Department uses a computer-based cash flow projection model (i.e., Student Loan Model, or SLM) and OMB calculator to calculate subsidy estimates related to the loan programs that are then recorded in the allowance for subsidy or liability account. The model uses multiple sources of loan data and hundreds of assumptions. In order to perform a check of estimates resulting from the SLM and OMB calculator, the Department prepares a backcast, which compares the model's estimates to actual activity for the current and prior fiscal years. The SLM for the prior year also produces a forecast of the expected cash flows in the current year for the outstanding loans. Rigorous comparisons of actual cash flows to the forecast prepared in the prior year (adjusted for new loans), to the backcast, and to the extent practical, recomputation of expected amounts based on loan volumes, interest rates and simplified cash flow assumptions can serve as a key detection control. The Department's efforts in this regard are evolving, and do not capture the full value of the SLM in providing a basis for robust budget to actual comparisons, or facilitate CRW participant assessments of the validity of the estimates derived by the SLM and OMB calculator. As a check, the Department should be able to reconcile the total amounts in the forecast to the allowance for subsidy and liability for loan guarantees and apply high-level analytics to assess the output.

Report on Internal Control

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- The early phase of the loan estimation process includes the development of the assumptions, which are used to populate the SLM with data that, in turn, feeds into the OMB calculator, which arrives at the actual cost re-estimates. In order to develop a majority of the assumptions, the Department utilizes the National Student Loan Database System (NSLDS) to extract a sample of loan data, which is known as the Statistical Abstract (STAB). The Department then executes internally developed computer programs to arrive at the assumption data that is entered into the SLM. While we understand some improvements have been made, we were informed that the programming language was not fully documented to explain the procedures executed by the programs. As a result, a review of the logic of these programs cannot be performed by someone unfamiliar with the code, which could have the potential of allowing undetected errors to exist in the development of the assumption data. Particularly in areas that have relatively less predictive capability in the existing model, we continue to advocate considering use of reasonable simplified assumptions in estimate development, which can result in simpler programs, thus establishing transparency and limiting the potential for errors.
- FFEL program receivables are classified as pre-1992 loans (liquidating account loans) and post-1991 loans (financing account loans). The Department records certain collections on each of these loan categories using an estimation process (splitter process), as this information cannot be obtained directly from cash collections. The allocation of collections between liquidating and financing loans ultimately affects the liability account for loan guarantees and accounts payable to Treasury. Currently, the Department relies primarily on the output of the credit reform model to record the net value of the pre-1992 loans. The Department should investigate methods to better evaluate whether the resulting split is occurring properly on an overall basis. The SLM develops cohort-level data and credit reform estimates, and the STAB and splitter process provide an estimate of cohort activity. The Department's financial systems are not configured to account for cash flows on a rigorous cohort level. We understand that creation of this functionality will be considered in FY 2006 by the CRW. Transition to such an approach is increasingly important to ensure that estimates in the subsidy models are appropriately adjusted as cohorts from the early 1990s wind down, and cash flows from default activities create temporary demands for cash that are currently funded on an aggregate basis across cohorts. The process may ultimately help resolve the splitter issues discussed above. In the interim, the development of additional analytical tools in this area could provide additional assurance as to whether the model is operating as intended.

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Recommendations:

We recommend that Federal Student Aid perform the following:

1. Continue to improve the analytical tools used for the loan estimation process. Ensure that all analytical tools reconcile with one another to allow for their use as detect controls for loan program cost estimates.
2. Document in detail the programs written to develop the assumptions for the SLM.
3. FSA should coordinate with the Department, including Budget Service, to continue to develop detailed operating procedures for the loan estimation process, which would include the step-by-step procedures that take place during the various phases of the process.
4. Efforts to more fully implement cohort reporting should continue. In the interim, analytical tools should be developed to assure the splitter process is operating as intended and that remaining credit reform estimates for each cohort are appropriate in relation to the remaining outstanding loans for such cohorts.

2. Controls Surrounding Information Systems Need Enhancement (Modified Repeat Condition)

In connection with the annual audit of FSA's FY 2005 financial statements, we conducted a controls review of the information technology processes related to the significant accounting and financial reporting systems. OMB Circular A-130, *Management of Federal Information Resources*, requires: (1) standard documentation and procedures for certification and accreditation of systems; (2) records management programs that provide adequate and proper documentation of agency activities; (3) agencies to develop internal information policies and procedures and oversee, evaluate, and otherwise periodically review agency information resource management activities; and (4) agency plans to assure that there is an ability to recover and provide service sufficient to meet the minimal needs of users of the system.

The Government Accountability Office's (GAO) *Standards for Internal Control in the Federal Government* identifies five components of internal control: Control Environment, Risk Assessment, Control Activities, Information and Communications, and Monitoring. With respect to the Control Environment and Monitoring components, GAO states that:

- "management and employees should establish and maintain an environment throughout the organization that sets a positive and supportive attitude toward internal control and conscientious management," and

Report on Internal Control

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- “internal control monitoring should assess the quality of performance over time and ensure that the findings of audit and other reviews are promptly resolved.”

While the Department and FSA have made progress in strengthening controls over information technology processes and have made improvements in the implementation of Certification and Accreditation initiatives during FY 2005, our audit work and audit reports prepared by the Office of Inspector General (OIG) identify certain repeated control weaknesses over information technology security and systems that need to be addressed. Audit resolution activity related to prior findings has generally been effective over time in addressing specific instances noted, and less so in applying lessons learned across other systems which may share similar attributes. This leads to a pattern of identifying similar findings as efforts are applied to different systems on a rotational cycle, rather than a holistic resolution of issues across all platforms.

More specifically, the Department and FSA should (1) consistently apply updates, virus/data integrity protection packages, and security patches to mission-critical systems; (2) enforce the use of complex passwords in all systems across the organization; (3) strengthen access controls to protect mission-critical systems (e.g., user provisioning process, periodic access revalidation, timely removal of user access); (4) improve the configuration management process to ensure consistent security configuration of servers and mainframe security packages across the organization and improve configuration settings to comply with best practices; and, (5) comprehensively review technical security weaknesses identified in prior audits in order to determine whether security controls have been fully implemented or adequately address the security weaknesses across the organization. The numerous repeat conditions noted in audit reports indicate that the control environment and monitoring components of internal control at the Department and FSA regarding information technology merit continued focus.

Recommendation:

1. Audit resolution activity has traditionally been focused around addressing the immediate security weaknesses identified by audit reports rather than a detailed evaluation of the root cause for the identified weaknesses, which is indicative of the number of repeat findings. We recommend that the Department and FSA continue efforts to address security weaknesses disclosed in audit reports with an emphasis on identifying and addressing the root cause of the security weakness, which should decrease the likelihood of a similar security weakness being identified in future audit assessments and internal self-assessments. Examples of addressing root causes may include, but are not limited to, additional training for the information technology professionals within the organization, updates to procedures to ensure proper configuration of servers against documented hardening standards at the time of deployment, and audit performance-based contracting with vendors providing system support services to the Department and FSA.

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STATUS OF PRIOR YEAR FINDINGS

In the reports on the results of the fiscal year 2004 audit of the Federal Student Aid financial statements, a number of issues were raised relating to internal control. The chart below summarizes the current status of the prior year items:

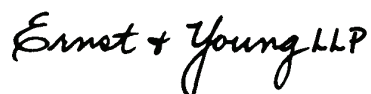
Summary of FY 2004 Reportable Conditions

| Issue Area | Summary Control Issues | FY 2005 Status |
|--|---|---|
| Improvements of Credit Reform Estimation and Financial Reporting Processes are Needed (Reportable Condition) | Management controls and analysis need to be strengthened over credit reform estimation and financial reporting processes. | Improvements Noted – Modified Repeat Condition Reportable Condition |
| Controls Surrounding Information Systems Need Enhancement (Reportable Condition) | Improvements are needed in overall information technology security management. | Improvements Noted – Modified Repeat Condition Reportable Condition |

We have reviewed our findings and recommendations with FSA management. Management generally concurs with our findings and recommendations and will provide a corrective action plan to the OIG in accordance with applicable Department directives.

In addition to the reportable conditions described above, we noted certain other matters involving internal control and its operations that were reported to management in a separate letter dated November 2, 2005.

This report is intended solely for the information and use of the management of FSA and the Department, OMB, Congress, and the Department's OIG, and is not intended to be and should not be used by anyone other than these specified parties.



November 2, 2005

Section VII
Report on Compliance
with Laws and
Regulations

Report on Compliance with Laws and Regulations

To the Inspector General
U.S. Department of Education

We have audited the consolidated balance sheet of Federal Student Aid (FSA), a performance-based organization of the U.S. Department of Education (the Department) as of September 30, 2005, and the related consolidated statements of net cost, changes in net position, and financing and the combined statement of budgetary resources for the fiscal year then ended, and have issued our report thereon dated November 2, 2005. We conducted our audit in accordance with auditing standards generally accepted in the United States; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and Office of Management and Budget (OMB) Bulletin No. 01-02, *Audit Requirements for Federal Financial Statements*.

The management of FSA is responsible for complying with laws and regulations applicable to the entity. As part of obtaining reasonable assurance about whether the entity's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws and regulations, noncompliance with which could have a direct and material effect on the determination of financial statement amounts and certain other laws and regulations specified in OMB Bulletin No. 01-02, including the requirements referred to in the Federal Financial Management Improvement Act of 1996 (FFMIA). We limited our tests of compliance to these provisions, and we did not test compliance with all laws and regulations applicable to FSA.

The results of our tests of compliance with the laws and regulations described in the preceding paragraph exclusive of FFMIA disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards* or OMB Bulletin No. 01-02. We noted certain other matters involving compliance with laws and regulations that were reported to management in a separate letter dated November 2, 2005.

Under FFMIA, we are required to report whether FSA's financial management systems substantially comply with the Federal financial management systems requirements, applicable Federal accounting standards, and the U.S. Standard General Ledger at the transaction level. To meet this reporting requirement, we performed tests of compliance with FFMIA section 803(a) requirements.

The results of our tests disclosed instances in which the Department's financial management systems did not substantially comply with certain requirements discussed in the preceding paragraph. FSA relies on the Department's systems to provide support for FSA's financial reporting needs, including utilizing the Department's general ledger to process transactions. We have identified the following instance of noncompliance:

Report on Compliance with Laws and Regulations

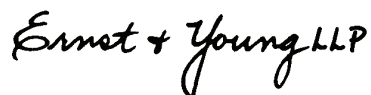
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While the Department has made progress in strengthening controls over information technology processes and has made improvements in the implementation of its Certification and Accreditation initiatives during fiscal year 2005, our audit work and audit reports prepared by the Office of Inspector General (OIG) identify certain repeated control weaknesses over information technology security and systems that need to be addressed. More specifically, the Department should (1) consistently apply updates, virus/data integrity protection packages, and security patches to mission-critical systems; (2) enforce the use of complex passwords in all systems across the organization; (3) strengthen access controls to protect mission-critical systems (e.g., user provisioning process, periodic access revalidation, timely removal of user access); (4) improve the configuration management process to ensure consistent security configuration of servers and mainframe security packages across the organization and improve configuration settings to comply with best practices; and (5) comprehensively review technical security weaknesses identified in prior audits in order to determine whether security controls have been fully implemented or adequately address the security weaknesses across the organization.

The Report on Internal Control includes additional information related to the financial management systems that were found not to comply with the requirements of FFMIA relating to information technology security and controls. It also provides information on the responsible parties, relevant facts pertaining to the noncompliance with FFMIA, and our recommendations related to the specific issues. We have reviewed our findings and recommendations with management of the Department. Management concurs with our recommendations and, to the extent findings and recommendations were noted in prior years, has provided a proposed action plan to the OIG in accordance with applicable Department directives.

Providing an opinion on compliance with certain provisions of laws and regulations was not an objective of our audit and, accordingly, we do not express such an opinion.

This report is intended solely for the information and use of the management of FSA and the Department, OMB, Congress, and the Department's OIG, and is not intended to be and should not be used by anyone other than these specified parties.



November 2, 2005

Section VIII Management's Response



START HERE GO FURTHER

FEDERAL STUDENT AID

November 10, 2005

MEMORANDUM

TO: John P. Higgins, Jr.
Inspector General

FROM: Victoria L. Bateman
Chief Financial Officer
Federal Student Aid

SUBJECT: AUDIT REPORTS
Fiscal Years 2005 and 2004 Financial Statement Audit
U.S. Department of Education
ED-OIG/A17F0005

Federal Student Aid wishes to express our appreciation for the efforts and professionalism of the Office of Inspector General and our auditors, Ernst & Young, LLP, in their audit of our fiscal year 2005 financial statements. We concur with the findings and recommendations as identified in the reports.

Federal Student Aid continues to support the Department of Education's efforts to address the reportable condition related to the credit reform estimation and financial reporting processes. We recognize that significant additional work remains to be accomplished in order for the Department to have a fully institutionalized practice.

We are committed to maintaining an unqualified opinion in future fiscal years and we will continue to prioritize corrective actions to eliminate reportable conditions and other matters as noted in this report. In addition, working with the Department, we will continue to implement additional improvements on controls over information systems.

Once again, we thank the Office of Inspector General and Ernst & Young for their efforts to complete a successful audit of Federal Student Aid's financial statements and internal controls.

